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AUTOMATIC BOOKKEEPING *via* ADDING MACHINE

DUPLICATING DEVICES *for* ACCOUNTANTS

EMPLOYERS' ACCOUNTING *under the* SOCIAL SECURITY ACT

THE TAX *on* UNDISTRIBUTED PROFITS IMPOSED *by* THE REVENUE ACT *of* 1936

SOME QUESTIONS *and* ANSWERS *on the* SURTAX *on* UNDISTRIBUTED PROFITS *of* CORPORATIONS IMPOSED *by* THE REVENUE ACT *of* 1936

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THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Objects of the Society

"To cultivate, promote and disseminate knowledge and information concerning accountancy and subjects related thereto; to establish and maintain high standards of integrity, honor and character among certified public accountants; to furnish information regarding accountancy and the practice and methods thereof to its members, and to other persons interested therein, and to the general public; to protect the interests of its members and of the general public with respect to the practice of accountancy; to promote reforms in the law; to provide lectures, and to cause the publication of articles, relating to accountancy and the practice and methods thereof; to correspond and hold relations with other organizations of accountants, both within and without the United States of America; to establish and maintain a library, and reading rooms, meeting rooms and social rooms for the use of its members; to promote social intercourse among its own members and between its own members and the members of other organizations of accountants and other persons interested in accountancy or related subjects; and to do any and all things which shall be lawful and appropriate in furtherance of any of the purposes hereinbefore expressed."

—From the Certificate of Incorporation.

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The New York Certified Public Accountant

THE NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS

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OFFICE OF THE SOCIETY
30 BROAD STREET · NEW YORK

Automatic Bookkeeping via Adding Machine

By Justin Jacobs, C. P. A.

Introduction

THE purpose of this article is to show how a standard adding machine may be utilized to create machine written records and eliminate much of the effort consumed in conventional ledger work. In the application of this system to customers' accounts, creditors' accounts, cost records, etc., no essential information need be sacrificed and fool-proof controls are established. However, the system herein described should not be blindly followed. It will function at maximum efficiency if it is modified to meet the special needs of the particular business of each individual client.

Great care should be exercised in the selection of equipment that is best suited to each special installation. The most important item of this equipment is the adding machine. Various types of machines are made with special features. We will illustrate this paper with a system applied to customers' accounts which is using an adding machine equipped with the following features:

1. Provision for printing dates.
2. Provision for printing credit balances.
3. Provision for printing symbols: dr., cr., and bal.
4. Direct subtraction.
5. Wide movable carriage.
6. Electric motor.

The System

Two sets of carbon copies of sales and credit invoices are used as office records. One copy is filed by invoice number, in the conventional manner, and forms the sales journal and the return and allowance journal. The other copy is arranged in a sorting tray and is then filed in individual customers' open item folders. Each folder carries the following information:

1. Name and address of customer.
2. Customer's symbol: A-1; A-2; A-3; A-4; etc., B-1; B-2; etc.
3. Credit information.
4. Sundry special information.

Debit invoices are filed in chronological order in the front part of the individual customer's folder and credit invoices are filed in chronological order in back of the debit invoices. A colored divider separates debits and credits. Now let us suppose that a remittance is received from Black & Co. (B-24), paying for ten invoices amounting to $350, less a credit of $50, and a discount of $30. The invoices covered by the remittance are removed from the open item folder. A duplicate remittance form is inserted in the adding machine, the debit invoices are added and the subtotal key depressed to show the $350. The credit and discount are then deducted and the total key de-

pressed to show the amount of the remittance. If this amount is in agreement with the check received, the duplicate of the remittance form is forwarded to the credit department. The original of the remittance form is attached to the invoices settled for and filed in the items paid during the current month file. In the above illustration a check for $270 should have been received. If the check amounted to $265, this amount would be deducted from the $270, leaving a balance of $5. In this case the duplicate of the remittance form would go to the credit department and the original would be attached to the respective vouchers and be filed in open item folder, B-24 (Black & Co.). The credit department would then advise the bookkeeper to charge off the $5, or leave it stand as an open item, to be included on the customer's statement, if not paid before the end of the month.

The foregoing procedures explain how the open item folders would at all times be, in effect, a customers' open item ledger. This is supplemented by permanent records, as will be explained in a subsequent paragraph.

Customers' statements are made in triplicate. Only the original is printed. Copies are separated by perforations. Before the end of the month, the name and address of each customer is typed on the statements. After the last item for the month is filed in the open item folders, the customers' statements are completed on the adding machine. A wide columnar trial balance form is then inserted in the adding machine and the balance shown on each statement is listed together with the respective customer's symbol. After the trial balance is proved with the control account, the statements are mailed in window envelopes. The duplicates of the statements form the bookkeeping department's customers' ledger and the triplicate is forwarded to the credit department.

The credit department files statement and remittance forms by customers and is thus able to obtain credit information more quickly than by reference to a conventional ledger account. The remittance forms automatically "Key-Off" each payment and graphically show the relationship of returns and allowances to sales. They give a complete history of each customer's account, with the exception of current unpaid items, which are shown at the end of each month, on the copies of customers' statements.

A daily control account is kept, showing the following columns listed from left to right:

1. Date.
2. Sales.
3. Returns and allowances.
4. Cash-debits.
5. Cash-credits.
6. Sundry debits.
7. Sundry credits.
8. Ending balance.

The total of each day's sales is obtained from the sales journal. This amount is proved by the daily detail control form which is prepared from

sales invoices, after they have been arranged in the sorting tray, but before they have been filed in the open item file. The daily totals of other items entered on the daily control account are likewise proved. At the end of the month, each column of the daily control account (with the exception of the balance column) is added and crossfooted to prove the balance at the end of the month and the totals of the respective journals which are summarized in the daily control account and listed in the preceding paragraph.

This system eliminates the inevitable errors inherent in conventional ledger work. All possibility of the following types of errors is thus avoided:

1. Failure to post an item.
2. Posting an item twice.
3. Transposition of figures in posting.
4. Posting a debit as a credit.
5. Posting a credit as a debit.
6. Error in adding debit side of ledger.
7. Error in adding credit side of ledger.
8. Error in "Keying-Off".
9. Error in computing balance of individual ledger accounts.
10. Error in control account.

In the system described in this paper, only three types of errors that will cause the trial balance to differ from the control account may occur:

1. Error in addition of customers' statements or trial balance. This type of error is quickly detected by checking because the original data is filed in the same order as the figures printed by the adding machine on the statements and trial balance.
2. Removing a bill too few or too many from the open item file. This type of error is quickly detected by running an adding machine tape of the items paid during the current month file. The invoices attached to each remittance minus the discount and amount of remittance should show no balance when the total key is depressed. A balance in any batch would locate the error.
3. Data removed from open item file in violation of instruction manual. The item missing will be easily located by checking against the daily detail control forms on which all debits and credits have been listed alphabetically.

After the trial balance has been proved, all data is transferred from the items paid during the current month file to the permanent file.

Duplicating Devices for Accountants

By LEWIS GLUICK, C. P. A.

Introduction

SOME accountants may feel that they have no special use or need for knowledge of duplicating devices. Whether they use them or not in their own offices is immaterial. Clients use them, and the accountant is supposed to be familiar with all office appliances so that he may properly advise his client. If your clients are not using any duplicating device there is a strong probability that they should be. Printers complain bitterly about business that has been lost the last few years. They formerly did business for groups who have now probably acquired devices, which for their purposes are just as good and sometimes even better than printed matter. Some of these duplicating devices will be on display at the exhibit to be held at the Waldorf-Astoria Hotel on Monday, October 26, 1936, in connection with the Fourteenth Annual Fall Conference of the Society and the manufacturers' representatives will be very glad to show them to you, and members of the Committee on Accounting Machinery will be glad to discuss their merits with you at any time.

Photographic Duplication

All duplicating devices are dependent to a greater or a lesser degree upon chemistry. They may be subdivided into two major classes; those that depend upon pressure and those that depend upon light. Of course, some of our great scientists say that light itself is a form of pressure, but the subject is still so moot that we will consider the two classes as given. Let us first take up the class which depends upon light. The first device is simple photography with which we are all familiar and the commercial application of which is found in Recordak. This device was exhibited at our 1933 meeting and the paper of Justin Jacobs, a member of the Committee on Accounting Machinery, explaining its use, was given at that time. A second device depending upon light is the very familiar photostat. This is really a special kind of camera device for the purpose of photographing documents of all kinds. Probably no reproducing device is more in use by certified public accountants. In fact, until the Recordak came into the field it was the only means whereby they could obtain copies of important papers which they wished to preserve when they could not keep the original. The courts generally hold that a negative is better evidence than a positive, but some attorneys say that if a positive is properly identified it is considered just as good evidence as a negative. Of course, nothing can take the place of the original document. I know one large company which, on the advice of its attorneys, will not accept any but negative photostats of the balance sheets prepared by its auditors, even for the administrative use of its directors.

Now comes a device seldom used by accountants, the blue print. This is not a photograph, althought somewhat akin to it, because it depends

upon the action of light upon paper specially treated with ferric salts. When light strikes the paper, the part which has not been written on turns blue because the fer*ric* salt becomes a ferr*ous* salt. Blue prints for the accountants have not much direct use, but any accountant who has any practice involving real estate or building contracts knows that if he is to make a proper audit of costs he must have continued reference to the blue print.

Pressure Duplication

We now come to the more common group of duplicating devices which are operated primarily by pressure. Obviously, the printing press is the oldest example of such devices. Accountants, unless they have a printer as client, have little direct contact with it, except as customers. As such they are usually much sought after by printers, because, although they are much more particular than most people about the quality of the work they buy, they recognize good work, and a satisfied certified public accountant is as good an advertisement as a job printer can have. Still, an intimate knowledge of what a printing press does, and how it does it, is not as necessary for certified public accountants as the knowledge of other duplicating devices.

A first cousin of the printing press has some application to our work. When I was in my first month of junior apprenticeship I worked in an office in which I saw a letter press in use for the first time. Now, for the benefit of those who have not seen the letter press in use, I want to explain what it is. Letters or any other documents are written with indelible ink. Then a piece of tissue paper is put over the letter and covered with a moist cloth, preferably linen, and the whole pressed down hard. The impression is thus taken up from the indelible ink on the tissue making as clear copies as the originals. It is operated by a scheme which permits the printing or copying of many letters at once. These were customarily copied into bound books. I understand that to this day the District Attorney's office and some of our older legal firms are still using it because the copies are exact and are held admissible as evidence, while carbons are seldom held admissible as evidence and are never satisfactory. It is quite common in our dramas, whether of stage or screen, representing a period more than forty years back to have a letter press in the scene, but only once since 1919 have I seen the letter press in any business office, and that, I was told, had not been used in years.

The reason for this is that carbon paper has become the nearly universal medium of copying letters, manuscripts, and many other kinds of business papers. It is so widely used that I will not attempt to describe it at all. I will add, however, that many grades of carbon paper are used. The quality which is satisfactory for making a single copy of a business man's letter is not the kind a certified public accountant would want to use in making five copies of an audit report; nor is it the quality which would be satisfactory to the certified public accountant making ten copies of a combined order and invoice form. I recently saw a form in use by a very large organization

which called for an original and eleven carbons. These were made satisfactorily by the rather common combination of a typewriter and a "fanfold" attachment. Of course, the thickness of the paper used must be taken into consideration.

The third type of duplicating devices seen frequently in use is known as the collotype class. This is dependent upon gelatin, which may be combined with wax or other ingredients, and usually requires an indelible ink. Then flat or roller pressure is applied to the base and copies struck off. There are many which do good work. For example, I saw one chain store regularly not only using the gelatin duplicating machine for sending out price changes and circular letters to its manager, but also to make copies of its daily, weekly, and monthly operating reports for distribution to executives. It was demonstrated that even though only fifteen copies had to be made they could be made just as fast as and more clearly than carbons and had less tendency to smudge. You will find the menus of many more or less expensive restaurants printed with such devices. The accountant who does not understand these devices is not able to render best services to his clients.

Another type of copying device is the stencil type. These machines work by means of cutting into specially prepared paper whatever is indicated to be duplicated. This may be done with the typewriter or by drawing. They are commonly called mimeo's. These devices have the great advantage of turning out a larger number of copies at one time at a relatively lower cost and are very popular for making circular letters. On the other hand they have these distinct disadvantages:

1. An error made in cutting the stencil is difficult to correct and usually results in a poor appearing job.
2. The quality of the paper on which the printing must be done is such that it is not adapted for permanent records.

Lithography

Another type of duplicating device which is now enjoying rapidly increasing popularity may be called the lithograph type. The original lithograph, as the derivation implies, (litho—Greek for stone; graph—to write) was the writing or drawing on smooth soft stone, whatever was intended to be reproduced. Then, by the use of a specially prepared greasy ink and the application of pressure, as many prints as desired could be made. As a matter of fact, it has been many a long year since lithographing in the true sense has been done by any but etchers and artists. Lithography for many years has been done on zinc plates. Now the newer and smaller machines are made with various metal alloys, of which zinc is the most important metal, but aluminum and other light metals play an important part. One of these machines which enjoys deserved popularity is small in size and the plates upon which the writing or designs are to be put are so thin that they may be run through the typewriter with no more difficulty than ordinary bond paper. If nothing but typing is desired, the plate may be put in the

machine and the impression taken therefrom. Manufacturers assert that as many as 100,000 copies can be made before clarity of the product is affected and if a heavier plate is used one half a million impressions may be made. These plates if purchased in quantities of 100 or more cost less than twenty-five cents apiece and since they may be used on both sides, the cost per sheet is very small. In addition to this advantage, anything at all may be cut, drawn, or photographed on these plates in as many as three colors. In the larger cities manufacturers operate service stations (like those maintained by the punch card people) to which merchants may send work which requires photographing or engraving, and I am told that in case of an ordinary job, work received before 10 o'clock in the morning will be delivered in New York City before 4 p.m. the same afternoon. In smaller towns the people send their work either to the local photo-engravers recommended by manufacturers; or if time permits, parcel post the work to the nearest service station in the big cities. The manifest advantage of this type of machine for the certified public accountant is evident if you consider the preparation of balance sheets or other financial statements which are to be distributed to a large number of creditors or stockholders. It is not necessary to send a typewritten copy to the printer, then proof read the printer's work, and then pray that you did a good job of proof reading. This work can be done in one's own office just as a paper report would be made and then one can make as many of these copies as desired and know that they are right. These metal plates may be preserved indefinitely as they are rust proof. Printers redistribute the type as soon as they run an order. The result is that you order more than you immediately require to take care of future requirements which may or may not come, or else you do not order enough and may later be compelled to have typed copies made, which is expensive in time and labor costs. One disadvantage is that the largest size sheet is 10" x 14" but a little care in the preparation of the balance sheet will overcome this difficulty.

Miscellaneous Devices

Other duplicating devices for the office are types using rubber, the most common example of which is the rubber stamp, the variety and multiplicity of whose uses need no explanation. A great deal of rubber is used in offset printing, with copies made for producing soft smooth color tones. Another device on exhibit today is a cross between a carbon copy and a lithograph. The copy is set up on a special kind of carbon paper; a flow of special acid keeps on making clear reproductions as the machine rotates.

I have not exhausted the subject or even the types of duplicating devices but I think I have covered the subject sufficiently for our purposes. If any of you desire more information at present, you probably can get it from our exhibitors and if these do not satisfy you, a glance at the Classified Telephone Directory will give you any or all you may need.

Employers' Accounting under the Social Security Act

By J. Andrew Crafts, C. P. A.

THE requirements of the Federal Social Security Act and of the related laws of the various states have placed upon the employer a specific responsibility for complete and accurate payroll records. Furthermore, it is now substantially mandatory that individual accounts be kept of each employee's earnings. In the case of those organizations having a large number of employees, the design and creation of these records, on a basis which will provide all of the information required for the reports to be filed and the calculation of the taxes prescribed, represents a task worthy of considerable time and study. It is essential that the information required under the regulations, as applying to the particular conditions present, be readily available and that the cost of actually preparing this information be kept to a minimum.

The basic features of the respective laws and the fundamental principles of the records required can best be set forth by the consideration of a case substantially free from complicating conditions and unusual features. For purposes of this discussion there is set forth below the requirements and suggested routines as applying to a manufacturing corporation located in the State of New York, employing 600 people, 500 being paid on the basis of an hourly rate and 100 on the basis of a weekly rate; all employees rendering their entire service within the State of New York and receiving only cash compensation; 20 shop foremen, included among those paid on the basis of an hourly rate, being considered as "employed at other than manual labor", 6 of whom receive over $50 per week or $2,600 per year.

Federal Social Security Act

The essential terms of the Federal Social Security Act applicable to the above case stated briefly are divided into three sections as follows:

1. *Federal Unemployment Insurance*

    (a) Every employer shall pay an excise tax with respect to having individuals in his employ, equal to the following percentages of the total wages payable by him:

During 1936	1%
During 1937	2%
Thereafter	3%

    (b) Payments made to New York State with respect to unemployment insurance may be taken as a credit against the tax prescribed in (a) up to 90% of the tax against which it is credited.

    (c) Returns are due on January 31st, next following the close of the taxable year and shall be filed with the Collector of Internal Revenue for the district in which the employer has his principal place of business.

(d) The tax may be paid in four installments.

2. *Federal Old-Age Benefit (employer)*

   (a) Every employer shall pay an excise tax, with respect to having individuals in his employ, equal to the following percentages of wages (up to $3,000 per year per employee) paid by him as follows:

During 1937, 1938 and 1939..............	1%
Thereafter—graduated upward to........	3%

   (b) Returns and payments are to be prescribed by the Commissioner of Internal Revenue.

3. *Federal Old-Age Benefit (employee)*

   (a) Every employer shall deduct from the wages of employees as and when paid an "Income Tax on Employees" with respect to employment equal to the following percentages of wages (up to $3,000 per year per employee) paid by him as follows:

During 1937, 1938 and 1939..............	1%
Thereafter—graduated upward to........	3%

   (b) Returns and payments are to be prescribed by the Commissioner of Internal Revenue.

New York Unemployment Insurance Law

The essential terms of the New York Unemployment Insurance Law applicable to the above case are as follows:

1. Contributions shall be payable by each employer equal to the following percentages of the payroll of employees, except as to any person employed at other than manual labor, at a rate of wages of more than $2,600 a year or of more than $50 a week.
2. Reports are prescribed monthly, to be filed on the 15th of each month for pay periods ending within the previous month.
3. Payment of the contribution shall accompany the report.

The above prescriptions do not cover many of the complicated questions and distinctions that an employer may have to settle as to his own particular situation but will serve to set forth the basic principles involved.

While the Federal authorities have issued no specific prescription as to the form or content of reports to be filed, the New York State authorities have issued three instructions, copies of which are available for distribution. For purposes of this discussion there is set forth below the pertinent portion of Instruction No. 1 and also the face of the form of monthly report prescribed by New York, as follows:

1. *Instruction No. 1*

   Employer's Records

   Each employer covered by the New York State Unemployment Insurance Law shall keep on his employment and payroll

records, with respect to each individual insured employee, beginning January 1, 1936, the following items:

(a) Insured employee's name.

(b) Wages earned during payroll period.

(c) Number of days worked during payroll period.

(d) Total number of hours worked during payroll period.

(e) Full scheduled hours per week for employees or group of employees.

(f) Date when employee quits or is "laid-off", either permanently or temporarily, or is discharged.

(g) Date employee is hired or reinstated after "lay-off" or is rehired.

(h) Place of employment (city or town).

Note 1: Space should be reserved on the employers' records for employee's insurance number which will probably be issued for New York State Unemployment Insurance identification and possibly for Federal Social Security Legislation.

Note 2: Provision should be made by employers for totalling above items (a), (b), (c) and (d).

2. *Form of Monthly Report (See Form 1)*

Form 1

LABOR—UI-1

DIVISION OF PLACEMENT AND UNEMPLOYMENT INSURANCE
DEPARTMENT OF LABOR, STATE OF NEW YORK
EMPLOYERS REPORT OF CONTRIBUTIONS

Enclosed is remittance for contributions covering period..............................
(Dates of reporting period)
as shown by summary of payrolls below, for pay periods *ending* within said reporting period.

Place of employment for employees reported on below..............................
(City or locality)

Duration of pay period (check one square) [W] Week [SM] Semi-Month [M] Month ....* Other

(Name and Address)

....
(Name)
....
(Street and Number)
....
(City and State)
....
(Employer's Registration Number)

SUMMARY OF PAYROLLS — *Insured Employees only*

(1) Date of end of pay period	(2) No. of insured employees on payroll	(3) Total hours worked by all insured employees	(4) Money wages	(5) Other remuneration	(6) Total earnings Cols. (4) plus (5)
TOTAL					

Contribution of 1% (1936) of total earnings — check enclosed $..............................
2% (1937)
3% (1938 and thereafter)

Please make checks payable to the New York State Unemployment Insurance Fund

See reverse side for explanatory note

The State of New York has also issued under "Instruction No. 1" two suggested forms of Payroll Record, one for persons employed on a salary or fixed stipend basis, where wages earned represents compensation for full time, and the other for persons who are paid on a piece work, hourly rate or other varying bases. These suggested forms are set forth in Forms 2 and 3 which follow.

Form 2

STATE OF NEW YORK

DEPARTMENT OF LABOR

DIVISION OF UNEMPLOYMENT INSURANCE

See reverse side of schedule for explanation of each item.

SAMPLE FORM

INSTRUCTION NO 1 — *EXHIBIT I*

ITEMS REQUIRED ON EMPLOYER'S PAYROLL RECORD

(Order of columns may be varied)

Form for persons employed on a salary or fixed stipend basis for the entire payroll period reported, where wages earned is compensation for full time.

Line 1. Employer's registration number, 25,155 *1a.* Payroll period ending January 10, 1936

Line 2. Name of employer, John Doe & Co. *2a.* Address 292 First Avenue, Yonkers, N. Y.

Line 3. Place of employment for employees listed below** Yonkers

Line 4. Full scheduled hours per week for employees listed below*** 35

Column 1 Employee Insurance Number	Column 2 See Notes 1 and 2 Insured Employee's Name (Need not be stated unless employee is newly hired, rehired or reinstated and has no insurance number)	*	*	Column 3 Wages Earned	Column 4 Other Remuneration
AL2555	Helen Smith			$15 00	$4 50
"H" Jan. 7	Jennie O'Grady			12 00	
RM4992	John Brown "R" Jan. 10			21 00	
AX5497	Peter Greenway			30 50	

Line 5. Total number of insured employees 4 *5a.* Total hours worked by insured employees, 140 *5b.* Total earnings (aggregate total of column 3 and column 4) $83.00

Note 1. Indicate with letter "R" in column 2, employees who quit or are laid off, either permanently or temporarily, or are discharged.

Note 2. Indicate with letter "H" in column 1 newly hired, rehired, or reinstated employee who has no insurance number.

* These spaces for employer's use for other items he now carries on his payroll.

** If all of your employees are not employed in the same place and there is not a sufficient number to require a separate sheet you can indicate different places of employment by drawing a line and entering in the middle of the form the place of employment of those employees listed below such break on the page.

*** If all of your employees do not work the same number of full scheduled hours per week and there is not a sufficient number to require a separate sheet you can indicate the fact that you have a different schedule of full time hours per week for certain employees by entering in the middle of the form the weekly hours of employment of those listed below such break on the page.

If it would be easier you may substitute for Line 4 a separate column for full scheduled hours per week for each employee.

12-3-35

Form 3

STATE OF NEW YORK

DEPARTMENT OF LABOR

DIVISION OF UNEMPLOYMENT INSURANCE

See reverse side of schedule for explanation of each item.

SAMPLE FORM

INSTRUCTION NO. 1 — *EXHIBIT II*

ITEMS REQUIRED ON EMPLOYERS' PAYROLL RECORD

(Order of columns may be varied)

Form for insured employees who are paid either on a piece work hourly rate or other varying basis.

Line 1. Employer's registration number, 11,253 *1a.* Payroll period ending January 30, 1936

Line 2. Name of employer, Doe-Clark, Inc. *2a.* Address 452 Madison Avenue, Albany, N. Y.

Line 3. Place of employment for employees listed below** Albany

Line 4. Full scheduled hours per week for employees listed below*** 48

Column 1 Employee Insurance Number	Column 2 (See notes 1 and 2) Insured Employee Name (Need not be stated unless employee is newly hired, rehired or reinstated and has no insurance number)	Column 3 Days Worked	Column 4 Hours Worked	*	*	Column 5 Wages Earned	Column 6 Other Remuneration
FB3472	Henry Black	3	21	-----	-----	$10 50	-----
WK9103	John Kaufman "R" Jan. 21	4	24	-----	-----	16 80	-----
"H" Jan. 15	Grace Hanlon	3	24	-----	-----	8 00	$2 50
BX7428	William Lefkowitz	6	48	-----	-----	25 00	3 00

Line 5. Total number of insured employees 4

5a. Total hours worked by insured employees, 117

5b. Total earnings (aggregate total of column 5 and column 6) $65.80

Note 1. Indicate with letter "R" in column 2, employees who quit or are laid off, either permanently or temporarily, or are discharged.

Note 2. Indicate with letter "H" in column 1 newly hired, rehired, or reinstated employee who has no insurance number.

* These spaces for employer's use for other items, *i. e.*, piece work data, etc., he now carries on his payroll.

** If all of your employees are not employed in the same place and there is not a sufficient number to require a separate sheet you can indicate different places of employment by drawing a line and entering in the middle of the form the place of employment of those employees listed below such break on the page.

*** If all of your employees do not work the same number of full scheduled hours per week and there is not a sufficient number to require a separate sheet you can indicate the fact that you have a different schedule of full time hours per week for certain employees by entering in the middle of the form the weekly hours of employment of those listed below such break on the page.

If it would be easier you may substitute for Line 4 a separate column for full scheduled hours per week for each employee.

12-3-35

Summary of Information Required

In order to determine the information which the payroll records must provide it is necessary to review carefully the requirements of the respective laws, the requirements of accounting and administrative control and the suggestions from the State of New York. The information required may be summarized as follows:

1. *For Administrative Control*

    (a) Names or clock numbers of all employees.

    (b) Total wages earned by each employee.

    (c) Total other remuneration of each employee.

    (d) Notation as to date hired or released, in the case of changes in the payroll.

    (e) Details of hourly rate and hours worked—regular and overtime—for employees paid on an hourly basis.

    (f) Details of deductions made from employees' earnings for stock purchase, group insurance, income tax withheld at source, old-age pension and the like.

    (g) Provision for proper receipts or vouchers for the distribution of the amount of net payroll.

    (h) Departmental totals of wages and other remuneration.

    (i) Totals of wages and other remuneration by classes of risk, having varying rates under the Workmen's Compensation and Public Liability insurance policies in effect.

    (j) Individual records of the earnings of each employee as a basis for filing income tax information at the source with the Federal and State governments, together with details of marital status and other factors bearing upon same.

2. *For New York Unemployment Insurance Law:*

    In addition to the information set forth under (1) above, the New York Law prescribes:

    (a) That the wages of any person employed at other than manual labor at a rate of wages of more than $50 per week may be excluded from the insured payroll. (This can be accomplished by segregating the payroll as between "insured" and "other".)

    (b) That the payrolls be segregated as to place of employment.

    (c) That the number of insured employees be set forth.

    (d) That the full scheduled hours per payroll period or actual hours worked shall be set forth for those employees as to which such information is not otherwise required.

    (e) That the number of days worked during payroll period be set forth.

    (f) That the aggregate amount of "contribution" paid to the State for each payroll period shall be available together with the calculation thereof and all supporting data.

3. *For Federal Unemployment Insurance Law:*

In addition to the information set forth under (1) and (2) above the Federal Unemployment Insurance Law requires only that there be summarized the total wages paid during the year, the Federal excise tax thereon, the credit for payments made to the State and the amount due.

4. *For Federal Old-Age Benefit (employer):*

In addition to the information set forth under (1), (2) and (3) above the Federal Old-Age Benefit (employer) Law requires the annual payment of an excise tax based on all wages paid to employees up to $3,000 per year per employee. (This calculation is identical with the deduction made on the payroll under (5) below and can be reflected in the general books from month to month in total only.)

5. *For Federal Old-Age Benefit (employee):*

In addition to the information set forth under (1), (2), (3) and (4) above the Federal Old-Age Benefit (employee) Law requires withholding and payment of an income tax based on all wages paid to employees up to $3,000 per year per employee. (This calculation can probably be made in the simplest manner from the individual records of the earnings of each employee and tabulated as a deduction on the payroll as it is made up.)

Form of Record

Having determined the information required the next step is the actual form of record to be used and the routine for preparation thereof. Bookkeeping machine equipment is desirable and economical on a payroll of any size. Tabulating equipment (punch card) may be desirable and economical on the very large payrolls, particularly when the same equipment can be used for other purposes. On small payrolls a wide carriage typewriter with certain attachments can be made to serve the same purpose.

Forms 4 and 4(a) attached are designed for a typewriter type of bookkeeping machine.

Hourly Payroll

The payroll of employees on an hourly rate is made up from the weekly time cards on which the regular time and overtime has previously been calculated in terms of elapsed hours and tenths of hours and extended at the effective rate, so as to set forth the gross earnings in terms of "Regular" and "Overtime Bonus." The time cards are segregated as between insured and noninsured employees (N. Y. Act) and are arranged by departments and in sequence of clock numbers within each department or group. If within any department there are different classes of workmen having different compensation or public liability insurance rates, the numbers should be grouped by such rates. On the payroll sheet the clock number; name and registration number; class code and rate are imprinted by an addressograph machine with listing attachment in the same sequence as the time cards are arranged.

Form 4

NUMBER OF INSURED EMPLOYEES

PAYROLL- WEEK EN

DEPARTMENT A

PAGE NO. 1

PERIOD ENDING	CHANGES SY	DATE	WORKED DAYS	HOURS	GROSS EARNINGS REGULAR	O. T. BONUS	DEDUCTIONS INSURANCE	MISC.	FEDERAL O. A.	NET EARNINGS
JAN21	T	1/17	5	40 0	24 00		15	ST 3 00	24	20 61
JAN21	R	1/17	2	16 0	14 40		15	N 5 00	14	9 11
JAN21			5	44 0	35 20	1 60	15		37	36 28

DEDUCTIONS:

Form 4(a)

INSURANCE .15 wk FEDERAL O. A.

A 3 ABC 76-8560
Thomas Brown 72 .80

PERIOD ENDING	CHANGES SY.	DATE	WORKED DAYS	HOURS	GROSS EARNINGS REGULAR	O. T. BONUS	DEDUCTIONS INSURANCE	MISC.	FEDERAL O. A.	NET EARNINGS
JAN 7			6	45 0	36 00	1 88	15		38	37 35
JAN14			5	40 0	32 00		15	T 2 00	32	29 53
JAN21			5	44 0	35 20	1 60	15		37	36 28

PERIOD ENDING	CHANGES SY.	DATE	WORKED DAYS	HOURS	GROSS EARNINGS REGULAR	O. T. BONUS	DEDUCTIONS INSURANCE	MISCELLANEOUS	FEDERAL O. A.	NET EARNINGS
JAN 21			5	44 0	35 20	1 60	15		37	36 28

FORM NO. 100

JAN21			5	47 2	25 96	1 98	15		28	27 51
JAN21			5	46 5	23 25	1 63			25	24 63
CLASS	3		59	523 0	278 51	33 28	1 35	6 00	3 11	301 33
JAN21			6	50 0	60 00	6 00	15	T 3 00	66	62 19
JAN21			6	48 0	57 60	4 80	15		62	61 63
CLASS		2N	12	98 0	117 60	10 80	30	3 00	1 28	123 82
GRAND	TO	TALS	153	1313 9	842 35	81 00	3 60	23 26	9 22	887 27

FORM NO. 102

SEVERSKY AIRCRAFT CORPORATION

ENDING JAN 21st 1937

CHECKED

APPROVED

	CHECK NUMBER	CLOCK NUMBER	NAME & REGISTRATION NO.	CLASS	RATE
61	1026	A 1	ABC 76-8212 James Wilson	62	.60
11	1027	A 2	ABC 76-8298 Joseph Osborne	92	.90
28	1028	A 3	ABC 76-8560 Thomas Brown	72	.80
	1029	A 4	ABC 76-8561 S. Richter	52	.70
	1030	A 5	ABC 76-8563 Grant Meutzell	52	.50
	1031	A 6	ABC 76-8564 Steve Franzen	52	.60
	1032	A 7	ABC 76-8565 Yeppi Wallace	52	.70
	1033	A 8	ABC 76-8566 W. Hoener	52	.80
	1034	A 9	ABC 76-8567 Wm. Hoffman	52	.40
35 53	1035	A 10	ABC 76-8568 J. P. Gunther	42	.40
28	1036	A 11	ABC 76-8569 F. M. Koal	42	.80
			ABC 76-8570		

SEVERSKY AIRCRAFT CORPORATION
SPECIAL PAYROLL ACCOUNT
FARMINGDALE, L. I., N.Y.

Pay to the order of ABC 76-8560
A3 Thomas Brown
Jan. 21 '37

1028

THE SUM OF 36 DOLLARS 28 CENTS $ 36.28

PAYEE MUST ESTABLISH IDENTIFICATION BY EXHIBITING MATCHING SIGNATURE CARD WATERMARKED SAME AS CHECK

[redacted]

	CHECK NUMBER	CLOCK NUMBER	NAME & REGISTRATION NO.	CLASS	RATE
	1047	A 32	ABC 76-8580 Chas. Lassington	83	.50
	1048	A 33	ABC 76-8581 R. Johnson	83	.55
	1049	A 34	ABC 65-8582 George Bassins	83	.50
51	1050	A 35	ABC 76-8583 J. Guists	83	.55
63	1051	A 36	ABC 76-8584 A. Biarrocca	83	.50
33					
19	1052	A 50	ABC 76-8585 Walter Dewey	N12	1.20
63	1053	A 51	ABC 76-8586 Charles Leitz	N12	1.20
82					
27					

210—Remington Rand Inc.,-19 284-3098—'36

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The employees record cards are arranged in the same sequence. The checks are imprinted on the addressograph with the clock number; name and registration number; the date of the check and authorized signature, all in one operation, and are arranged in the same sequence as the other data.

The payroll sheet is inserted in the bookkeeping machine as in any typewriter. The employees record card is inserted in the machine through a "front feed" or other type of device and registered with the payroll sheet as to columns and as to proper writing line. The check is also inserted and registered. Carbon paper is used in front of the payroll sheet while the stub of the check is "spot carboned" from left to right through the check number column. As the check and employees record card are picked up by the operator they are compared as to clock number and name with the next name on the payroll to be sure that the arrangement has not been disturbed. The date of the period ending is typed (1 date key), changes are noted by Symbols: H = Hired, R = Released and T = Transferred to Another Department. The date of the change is noted. Days and Hours Worked, Gross Earnings — Regular and O. T. Bonus are noted from the time card. Deductions are filled in from the notations at the top of the employees record card. Attention is called to the fact that the miscellaneous deductions column is wide enough to permit the use of code symbols to the left of the figures to indicate the class of deduction. The net earnings are copied from the cross footer or cleared therefrom, depending on the machine used. The net earnings figure is then filled in twice on the check without any carbon copy thereof and the check and employees record card removed from the machine. The machine carriage returns automatically and spaces up to the next writing line for the start of the next entry.

Totalizers or registers are provided on the machine for the accumulation of Hours Worked, Gross Earnings — Regular, Gross Earnings — O. T. Bonus, each Deduction column and for the numerical amount on the check. This last accumulation is used for the purpose of proving the fact that the amount copied on the check agrees with the total of the net earnings column.

The machine totals for each department are cleared on the payroll sheet and summarized later as between insured and non-insured payroll.

No provision is made for the accumulation of totals to date on the employees record card as to gross earnings because of the fact that two more columns would be required for Pick Up and Total to Date and the machine operation would be slowed down to some extent. If desired, however, this provision can be made. Otherwise the employees record cards can be footed as required by comptometer operators or otherwise. The use of the addressograph can be dispensed with and the entire data typed on the machine with or without a complete copy of the check data imprinted on the payroll sheet and even on the employees record card. The imprint of the employees' clock number and/or name on the employees record card may have some advantages as a partial insurance against posting to the wrong card, although with proper precautions this should not be necessary.

Weekly Payroll

The payroll of employees on a weekly basis is made up from notations of rates and deductions set forth on the top of the employees record card. No notation of the rate is placed on the addressograph stencil. With this exception the same principles apply as in the case of the hourly payroll. In either case the point at which the deductions for Federal Old Age Tax stop ($3,000) must be noted on the employees record card for the machine operator as well as intelligible instructions as to other deductions.

While checks are being used to an increasing extent for payroll departments, there are certain restrictions as to their use by the State Department of Labor and permission must be obtained from such department for their use. If payments are to be made in cash, the same payroll and employees record card forms can be used, substituting for the check a form of voucher showing the details of earnings and deductions the same as the check stub with a form of receipt attached in lieu of the check. This voucher can be used with a payroll envelope in such a manner that when folded and inserted under the flap of the envelope only the receipt form projects. This can be detached and signed by the employee upon delivery of the envelope. A suggested form is set forth in Form 5.

Form 5

PERIOD ENDING	CHANGES		WORKED		GROSS EARNINGS		DEDUCTIONS			NET EARNINGS	RECEIPT NUMBER	CLOCK NUMBER	NAME & REGISTRATION NO.
	BY	DATE	DAYS	HOURS	REGULAR	O.T. BONUS	INSURANCE	MISC.	FEDERAL O.A.				

KEY TO - MISC. DEDUCTIONS

EMPLOYEE'S PAY RECEIPT

DATE

RECEIVED PAY FOR WEEK ENDING AS DATED ABOVE-

EMPLOYEE'S SIGNATURE

Form 6

PAYROLL RECAPITULATION

PAYROLL- Week Ending January 21, 1937

CHECKED ______________

APPROVED ______________

DEPARTMENT & GROUP	NO. OF EMPLOYEES		WORKED		GROSS EARNINGS		DEDUCTIONS			NET EARNINGS	EMPLOYERS TAXES				COMP. INSURANCE		PUBLIC LIAB. INS.	
											UNEMPLOYMENT			FEDERAL OLD AGE				
	INSURED	OTHER	DAYS	HOURS	REGULAR	O.T. BONUS	INSURANCE	MISC.	FEDERAL O.A.		FED.-GROSS	NEW YORK	FED. - NET		RATE	AMOUNT	RATE	AMOUNT
Department A:																		
Insured-New York																		
Comp. and P.L. Ins.																		
Class 2			82	692 9	446 24	36 92	1 95	14 26	4 83	462 12					1 96	9 47	1 50	7 25
Class 3			59	523 0	278 51	33 28	1 35	6 00	3 11	301 33					2 25	7 02	1 50	4 68
Total Insured-New York				1,215 9	724 75	70 20	3 30	20 26	7 94	763 45		7 95						
Not Insured-New York																		
Comp. and P. L. Ins.																		
Class 2			12	98 0	117 60	10 80	30	3 00	1 28	123 82					1 96	2 52	1 50	1 93
Total Department A.			153	1,313 9	842 35	81 00	3 60	23 26	9 22	887 27	9 23	7 95	1 28	9 23	6 17	19 01	4 50	13 86

Payroll Recapitulation

Upon completion of the payroll a recapitulation can be made in such a form as to provide the necessary general ledger entries and the information for making up the respective reports required under the Social Security Laws. There is set forth in Form 6 a suggested form of recapitulation.

In Form 6 the group totals reflected on the payroll itself will be copied on the bookkeeping machine so as to arrive at the major group totals and a grand total for each column concerned.

It will be noted that this recapitulation provides for group totals for each department, sub-divided within the department as between insured (N. Y.) and other, with a further breakdown under these two sub-groups as between the various classes of risk for purposes of compensation and public liability insurance. From the total of insured payroll under each department the Employers' Unemployment Tax — New York can be extended by multiplying such total by the prescribed rate. From the departmental totals the Federal Unemployment Tax — Gross can be extended by multiplying said total by the prescribed rate. The Federal Unemployment Tax — Net can be determined as to each department or in grand total by subtracting the credit for payments made to New York from the Federal Unemployment Tax — Gross, due allowance being made for the fact that the credit for New York State tax is limited to 90% of the gross Federal tax. The Federal Old-Age Employers' tax can be determined by repeating the corresponding figures already entered under deductions. The rate for the respective classes of compensation and public liability insurance risk as set forth in the recapitulation should be noted in the columns provided and extensions made by multiplying by the related group totals. Upon completion of the entry of all group totals and the extension of the respective taxes and insurance charges, grand totals can be obtained so as to provide all necessary information for the general ledger entries concerned and for the necessary payments under the Federal and State Social Security Acts.

The above described routines represent one type of procedure using one general type of equipment. It is set forth merely as an example to illustrate the principles involved and the possibilities as to the handling of the facts. The details of the routine will necessarily have to be modified to meet the particular requirements of an individual employer. Numerous variations are possible to meet special conditions, to adapt the routine to various types of equipment or to meet the particular ideas of individual executives. It is possible to handle this routine on any one of a number of standard types of accounting machines available, such as tabulating equipment (punch cards), typewriter type bookkeeping machines, "flat bed" bookkeeping machines and the adding machine type of bookkeeping machines having no typewriter keyboard.

The extension of the time set forth on the time cards at the various prescribed rates can be handled by any one of the various types of calculating machines available or can be handled by prepared tables covering the range

of hours and the range of rates necessary to handle the scope of the calculations concerned. It is possible to obtain these tables already prepared on rolls to meet any requirements for recurring calculations, so arranged mechanically as to render the answers quickly available. In surmounting some of the difficulties of making it possible to pay employees by check and to facilitate the cashing of checks by employees, it may be very helpful to make use of the services available through certain companies in making arrangements with trades people, stores, banks, etc., to cash employees' checks under a prescribed routine and with certain guarantees against losses in connection therewith.

The Tax on Undistributed Profits Imposed by The Revenue Act of 1936

By Henry B. Fernald, C.P.A.

I. Introduction

THE Revenue Act of 1936, by Section 14, imposes a "surtax on undistributed profits". This tax has been imposed at the suggestion of the President, by a law passed by Congress and approved by the President. Accordingly, whatever we may think of it as unfair, unreasonable, impossible of sound administration and undesirable in its economic effects, and whatever we may think of the statute which imposes it as being ill-considered, hastily drafted, indefinite, confusing and at points practically uninterpretable, nevertheless, we must recognize that this law has been passed and the tax has been imposed. No one is more disposed than I am to criticize the nature and effect of this tax and the manner in which it was imposed, but for this very reason I must recognize what has been done and the seriousness of the resulting situation with which the taxpayers of the country are confronted.

My criticism is not against the legislative draftsmen who probably did the best that could be done to comply with their instructions to write into the law the substantive and administrative provisions to make effective such a tax as the Administration recommended and Congress approved and to do this in wholly inadequate time under grievous pressure so that Congress might adjourn to permit its members to attend a political convention.

Years of experience have shown the wisdom of having a proposed revenue bill made the subject of public hearings where its proposed provisions could be subject to criticism and discussion both as to their practical effect and as to their technical expression in the law. This procedure was abandoned this year. Hearings by the House Committee were held before any bill was drafted. The only public hearings held on this bill after a draft of it was made public were when the Senate Committee on Finance held its hearings with respect to the bill passed by the House. These hearings resulted in a virtual rewriting of the corporate tax provisions, but no public hearing was ever held on the provisions of the Senate Bill nor on the Conference Agreement as finally enacted into law and approved by the President. Accordingly, the taxpayer must expect to find in the law provisions that never could have survived hearings at which taxpayers might have had opportunity to point out the inequities and deficiencies of the law. The taxpayer should then rather expect to find in this law provisions which will seem illogical, unreasonable and drastically unfair.

The proposal for a tax on undistributed corporate profits is not new. For years the possibility of such a tax has been the subject of consideration and study by economists and tax authorities. Their conclusions have generally been that any such tax as that now enacted into law would be admin-

Presented at a special meeting of The New York State Society of Certified Public Accountants on September 21, 1936.

istratively impracticable and economically undesirable. The characteristics of such a tax have long been recognized. To be practicable of administration and effective in accomplishing its purposes, simplicity would have to be attained, but such simplicity could only be attained by imposing a drastic tax, with practically no exemptions or relief provisions. Such a tax, however, would be economically undesirable. A plan which subjects to a penalty tax the profits of any year which the corporation does not distribute to its stockholders, even though it has used them for the reasonable needs of the business or ought to retain them for such reasonable use, rests lightly, if at all, on the corporation which is in a position to distribute all its profits, but becomes a crushing load on corporations which cannot or should not make such distributions. This means that the strong, well-established corporation, with its requirements for fixed and working capital fully met by its capital contributions or accumulated surplus, will not need to pay this tax. On the other hand, the tax may have to be paid by the less fortunate corporations; those struggling to recover from the effect of past losses, those trying newly to get a foothold, those trying to build up a business of increasing volume, those trying to pay off prior indebtedness.

If the law tries to give relief in all cases in which relief should equitably be extended, it must include a long series of qualifications and limitations, difficult to phrase and to administer, or it must place great discretion in the tax authorities or in the courts to determine when the tax should and when it should not apply. This is the kind of tax we have long had which is continued in Section 102 of the Act as a "surtax on corporations improperly accumulating surplus". This involves the questions of whether earnings or profits are permitted to accumulate beyond the reasonable needs of the business and whether the corporation is formed or availed of for the purpose of preventing the imposition of the surtax on shareholders. These questions of judgment as to the reasonable needs of the business and as to the intent of avoiding the surtax on stockholders are so difficult that the Bureau has not felt that it always had the freedom it wished in trying to apply this tax, even though it has recently made and is continuing to make renewed efforts widely to impose this tax.

We cannot measure how much corporations may have paid in dividends which they would not have paid except for the threat of this tax of Section 102, but undoubtedly it is very large. Of course, such a tax will not apply to those cases where earnings are actually used for the reasonable needs of the business.

The reason for the statements I have been making and for some I shall make is to bring out how the tax now imposed on undistributed profits differs from any tax which we have ever had before. The present tax is to be imposed regardless of any reasonable needs of the business and regardless of any financial necessities of the taxpayer. It is to be drastically imposed according to the arbitrary definitions and standards of the law, with a minimum of exemptions and relief provisions. A clear recognition of this is essential to a proper consideration of this tax.

Perhaps it is also essential to a proper understanding of the nature and effect of this tax that we should consider the income tax situation as it exists. The Revenue Act of 1935 had imposed taxes on individual incomes on a schedule which quickly passed the rate of tax imposed on corporate incomes. A man with $100,000 of surtax net income was running into the 58% bracket. Naturally, he would look to a 15% corporate tax rate as a possible relief. The special tax on personal holding companies only applied to such corporations as were specified in the Act. It was seen that the high individual surtax rates would prove largely ineffective unless some means could be found to compel corporations to distribute their incomes, since the Federal Government seems without power to tax the individual stockholder on the undistributed income of a corporation. The Federal Government also seems without power directly to compel corporations to distribute corporate incomes. So the previously discarded proposal for drastic taxes on the undistributed incomes of corporations was grasped as a remedy to be applied. In this connection the individual tax rates were, in effect, still further increased by withdrawing the exemption which had previously attached to dividends and making the 4% normal tax rate applicable to dividends as well as to other incomes. The economic consequences which had previously been considered weighty objections to such a tax as this seem rather lightly to have been brushed aside with the doctrine that the general prosperity of the country would be better served by having the corporate earnings liberally distributed to stockholders and liberally spent by them than by having the funds retained and used for business purposes, even though this tax might mean the bankruptcy of many existing businesses, the restriction of activities of others, and the discouragement of new business enterprises.

II. Some Examples of the Practical Effect of the Tax Rates of the Present Law

To illustrate how serious the tax situation is and how the high tax rates discourage business investments by men of wealth, let me give to you as accountants a few figures which will illustrate this situation. I shall use the rates of the new law, but state the taxes in round amounts without trying to consider the minor differences which may result from personal exemptions, etc.

A man with $100,000 taxable income is already in the 59% bracket (combined normal and surtax). If he received an additional $100,000 of income either from the business he operated individually or through a partnership or in dividends from a corporation, the tax on this at the 62% and 64% applicable rates would be $63,000. Of this second $100,000 he would then have left for himself only $37,000. However, $100,000 income of a corporation would only be subject to a 15% normal tax rate (actually the lower rates on the first $40,000 of its income would make its tax only $13,840 but for convenience in comparison we may use the $15,000 figure). If, then, this $100,000 of earnings was accumulated in a corporation without paying an undistributed profits tax or tax under Sections 102 or 351, there would be a saving

to him of 48% or $48,000. With the undistributed profits tax imposed which will average 20½% of adjusted net income or 17.425% of net income, the corporation would have to pay a total tax of about $32,000, but this would still be about $31,000 less than if he individually received this amount in addition to $100,000 of other taxable income.

The Government feels, therefore, that such a man has little ground to complain of the undistributed profits tax. It still leaves to him a substantial corporate refuge, providing, of course, that the funds can be used for the reasonable needs of the business so that a further tax under Section 102 will not also be imposed. Even if he should have to pay an additional tax under Section 102 (a) (2) of 15% on 68% of the corporate profits (after deducting normal tax and undistributed profits tax) the total taxes on the corporation would only be some 43% as compared with a possible 63% he would have to pay if he individually received these profits.

Of course, we may carry this further and figure that if the profits were earned by the corporation and it paid a 15% corporation tax with the remaining 85% distributed to him in dividends, the aggregate of corporate and individual tax on those profits would be 68%.

We may also recognize that if the man with $100,000 of other income were personally conducting this business and it sustained a loss of $100,000, he might then deduct that loss from his other income of $100,000 and so save a tax of $34,000 which he would otherwise have to pay. So in such a case we might say that if the business conducted by him individually lost $100,000 he would only have to bear a net 66% of the loss but if it made $100,000 profits he would only have left to him 37% of the profits. Then we may try to evaluate this as against the situation if the business was conducted by the corporation, where if it lost $100,000 a year the corporation would have to stand the entire $100,000 loss but if it made $100,000 net a year, the corporation would only have left 68% of the profits. Neither a venture where you stand 66% of a loss but receive only 37% of a profit, nor a venture where you stand 100% of a loss but receive only 68% of a profit, seems very attractive from an investment standpoint.

Consider further the possibilities for such a man if he plans an investment in a business which he figures may earn $100,000 net income a year after it has sustained $100,000 a year loss in each of its first two years.

(a) If he were to conduct the business individually he would see possible results for the first five years under the present tax law somewhat as follows:

	Net Income or Loss from Business	*Tax (—) or Tax Saving (+)*	*Net*
First Year—Loss	—$100,000	+$ 34,000	—$ 66,000
Second " "	— 100,000	+ 34,000	— 132,000
Third " —Income	+ 100,000	— 63,000	— 95,000
Fourth " "	+ 100,000	— 63,000	— 58,000
Fifth " "	+ 100,000	— 63,000	— 21,000
Total for 5 years	+$100,000	—$121,000	—$ 21,000

The net result for the first five years on such a basis would be that the business would have made a net amount of $100,000 against which the Government would have received $121,000 in taxes with a net deficit to the investor for the five-year period of $21,000. This certainly does not look attractive to the investor, however nice it may seem as to Government revenues.

(b) Suppose then he looks at the situation of a corporation and finds as follows:

	Net Income (+) of Loss (—)	*Corporation Tax*	*Surplus (+) or Deficit (—)*
First Year—Loss	—$100,000	0	—$100,000
Second " "	— 100,000	0	— 200,000
Third " —Income	+ 100,000	$32,000	— 132,000
Fourth " "	+ 100,000	32,000	— 64,000
Fifth " "	+ 100,000	32,000	+ 4,000
Total for 5 years	+$100,000	$96,000	+$ 4,000

This is not quite so bad because out of net $100,000 profit to the corporation only $96,000 would have had to be paid to the Government as taxes, leaving a net of $4,000 to the corporation. However, this also is not much inducement to the investor.

(c) Suppose he notes some of the plans whereby a corporate deficit could be expunged so that the corporation might then distribute all its earnings of any year in which it has earnings, he then might make a computation as follows:

I. For the Corporation:

	Net Income (+) or Loss (—)	*Corporation Tax (—)*	*Contributed by Stockholders (+) Dividends (—)*	*Corporate Surplus*
First Year—Loss	—$100,000	0	+$100,000	0
Second " "	— 100,000	0	+ 100,000	0
Third " —Income	+ 100,000	—$15,000	— 85,000	0
Fourth " "	+ 100,000	— 15,000	— 85,000	0
Fifth " "	+ 100,000	— 15,000	— 85,000	0
	+$100,000	—$45,000	—$ 55,000	0

Accordingly, then, out of its net profits of $100,000 the corporation would have had to pay $45,000 in taxes and would have distributed to its stockholders $55,000 more than the contributions to surplus which it received from them.

II. Individual Taxes:

The individual will have no allowance for the $200,000 contributed to surplus but on $85,000 a year which he received for 3 years, his tax, at the 62% and 64% rates, would be $53,000 a year.

His individual taxes for 3 years would be—$159,000.

In such a case the net profits of $100,000 from the 5 years operation of the business would be subjected to $204,000 aggregate corporation and individual taxes, leaving $104,000 net deficiency, after taxes. This certainly offers no inducement to the investor.

I have stated this for a single investor with $100,000 of other income. Similar results might be shown if this investor were one of a group of investors considering such a proposal. Those of you who are interested can follow through similar computations for different amounts of income, different tax rates and under different conditions to see what, if any, kind of a business investment would, under present tax laws, be attractive to a man of wealth.

The economic question here involved is not as to whether a man such as this needs more than $100,000 income a year; it is whether the country can afford by such tax rates to drive out of industry the funds which men of wealth might be investing but which we cannot expect them to invest under such tax rates. It is a question of whether it is better to take these funds and have them expended through political channels or to have them employed in productive industry, creating wealth for the country, using the raw materials and giving employment to labor.

However, my real purpose in giving these illustrations is to show the proposition with which the Treasury is confronted in trying to make effective the high surtaxes on incomes of individuals and to emphasize the spirit in which the undistributed profits tax has been imposed. So throughout your consideration of this tax law, remember that deliberately, intentionally, it has been framed to impose taxes on the profits of one year without regard to the losses of other years and to impose taxes on an arbitrarily defined net income even though the taxpayer has an actual loss for the year. The effect of the tax law on business and business investments seems not to have been considered a matter of any material importance to the Government.

III. The Surtax on Undistributed Profits
Some of Its Technical Provisions and Some of Its Practical Problems

Passing now from the general to the specific, we may with this foundation consider some of the technical provisons of the new tax on undistributed profits and some of the practical problems which it raises.

1. The surtax on undistributed profits is an income tax imposed on the income of all corporations except those to which the law gives exemption,— Section 14 (d) and (e), T.D. 4674, Article 14-5. Among the exempt corporations are banks, insurance companies, corporations in bankruptcy or receivership, foreign corporations, etc., to the extent the law sets forth and subject to its definitions and limitations.

Note here, that a corporation which, although loaded with debt, is struggling to get back on its feet, and has been permitted to stay out of receivership because the creditors have confidence in the integrity and ability of its management, may have to pay the full undistributed profits tax, whereas

if this corporation were insolvent and in receivership in any Federal or state court it would not be subject to the undistributed profits tax.

We seem to have no decision as yet on whether or not a corporation in reorganization under 77(b) is to be considered exempt.

2. The tax applies only to taxable years beginning after December 31, 1935. It applies for the calendar year 1936 for corporations which render their income tax returns by calendar years. It applies to the first fiscal year which begins in 1936 for corporations which file income tax returns by fiscal years. Section 1.

3. The tax computation starts with "the net income" as this is defined in Section 21 which means the gross income computed under Section 22, less the deductions allowed by Section 23. Due consideration must be given to the provisions of Section 24 regarding items which are not deductible and the provisions of Sections 41, 42, 43 and 44 as to the basis for computing net income, the period in which items of gross income are included, the period for which deductions and credits are taken, and the provisons regarding installment basis. Also consideration must be given to Section 117 (d).

Note the change in the provision with respect to dividends received from domestic corporations which under the 1934 Act (Section 23 (p)) were allowed as deductions from gross income and consequently were not included in "net income". Under the new Act such dividends are included in the amount of net income but a credit for 85% of their amount is allowed by Section 26 (b) and Section 13 (a) (2) in computing the normal tax and also allowed by Section 402 (a) in computing the excess-profits tax, but such credit is not allowed as a deduction in computing the undistributed profits tax.

For example, if a corporation's entire gross income of $100,000 consisted of such dividends and it had $20,000 of allowable deductions, its net income would be $80,000. Its credit under Section 26 (b) would be $85,000 and it would have no "normal-tax net income" within the meaning of Section 13 (a) and no normal tax to pay. However, under Section 14 its adjusted net income and its undistributed net income would be $80,000 unless it had some of the other credits or allowances there specified.

4. "Adjusted net income" means net income less

"(a) The normal tax imposed by Section 13.

(b) The credit provided in Section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(c) In the case of a holding company affiliate (as defined in Section 2 of the Banking Act of 1933), the amount allowed as a credit under Section 26 (d).

(d) In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under Section 26 (e)."

The matter is so complicated at best that to simplify it as far as I can I shall consider that we are dealing with a corporation which is not concerned with these items (b), (c) and (d) but for which its adjusted net income is the amount of its net income less the normal tax imposed by Section 13.

However, I would here introduce the caution that if you do have occasion to consider the meaning of the terms "a holding company affiliate", "a national mortgage association" as well as in considering the terms "net income", "dividends paid" and other wording of the Act, you must not draw on your imagination as to what you think the terms should mean or what you might reason as to the ordinary meaning of such terms in general use. The sole question is as to the definition which this law gives to those terms as it uses them in respect to the undistributed profits tax.

5. "Undistributed net income" is "adjusted net income" less the dividends paid credit under Section 27 and the credit provided in Section 26 (c) relating to contracts restricting dividends.

Here again let me caution as to the meaning which the law gives to these terms. No matter how effective contract provisions may be in restricting or preventing payment of dividends, they do not give rise to the credit in computing the undistributed profits tax unless they are such contracts as would fall strictly within the provisions and limitations of Section 26 (c). Even then you may find that the credit is in whole or in part denied if the Department is correct in its position set forth in Article 26-3 of T.D. 4674.

Also as to dividends, do not get confused as between what the applicable State corporation law may class as dividends and what are the dividends under Section 115 of this Act and the dividend credits under Section 27, to which I shall later refer.

Since I think there will be so few cases in which the credit for contracts restricting dividends will be applicable, I shall here assume that we are dealing with a corporation which does not have such credit so that undistributed net income is the adjusted net income less the dividends paid credit.

6. We shall then here consider the usual corporations which will have the computation as follows:

(a)—Net income.
(b)—Less—Normal tax.
(c)—Adjusted net income.
(d)—Less—Dividends paid.
(e)—Undistributed net income.

It is the ratio of (e), Undistributed net income to (c), Adjusted net income which determines the rate of undistributed profits tax.

7. The surtax on undistributed profits is stated by brackets according to the percentage which "undistributed net income" bears to "adjusted net

income". These brackets may be summarized with cumulative percentages stated as follows:

	% of Undistributed Net Income to Adjusted Net Income		Rate of Tax on Undistributed Net Income
On first	10%	@	7%
On next	10%	@	12%
Average on	20%	=	9½%
On next	10%	@	17%
Average on	30%	=	12%
On next	10%	@	17%
Average on	40%	=	13¼%
On next	10%	@	22%
Average on	50%	=	15%
On next	10%	@	22%
Average on	60%	=	16⅙%
On next	10%	@	27%
Average on	70%	=	17$\frac{5}{7}$%
On next	10%	@	27%
Average on	80%	=	18⅞%
On next	10%	@	27%
Average on	90%	=	19$\frac{7}{9}$%
On next	10%	@	27%
Average on	100%	=	20½%

For the special credit if "adjusted net income" is less than $50,000—See Section 14 (c) and T.D. 4674, Article 14-4.

Let us take as a practical illustration the case of a corporation with $100,000 of net income, (no part of which is from dividends received) and which pays $50,000 dividends to its stockholders. We may then compute its tax as follows (shortening the computation by taking advantage of the cumulative rates as stated in the foregoing table):

Net income	$100,000.00
Normal tax—15%, less a differential of $1,160 for lower rates on first $40,000 of net income................	13,840.00
Adjusted net income	$ 86,160.00
Dividends paid	50,000.00
Undistributed net income	$ 36,160.00
Undistributed profits tax:	
On $34,464 (40%)—@ 13¼%..............	$ 4,566.48
On balance 1,696 —@ 22%................	373.12
$36,160	$ 4,939.60

Accordingly, then, this corporation would pay $4,939.60 undistributed profits tax because of the $36,160 of its statutory net income which was in excess of the amount of its normal tax and the amount of its dividends paid to stockholders.

This is the tax regardless of the reason why the corporation failed to make the distribution, assuming, as we have here assumed, that it is not entitled to one of the special credits or allowances which the law specifies.

8. Let me illustrate a few of the conditions which exist but which will not in any way prevent the imposition of this tax:

(a) The income may never have been actually received in cash but may simply be represented by accruals or receivables. Nevertheless, these are properly to be included in net income and in undistributed net income (if the corporation is on an accrual basis).

(b) The income received may have been expended for increased inventories or for capital additions or other non-deductible items.

(c) Income may have been used for the payment of indebtedness or for sinking fund on bonds, which do not fall within the narrow limitations of the credit of Section 26 (c).

(d) A corporation may have a statutory net income for the year but may not have any net earnings or profits for the year, as, for example, if it has had capital net losses not allowable by Section 117 (d). (Although allowance is made for such losses in computing the taxes under Section 102 for corporations improperly accumulating income or Section 351 for personal holding companies, such losses are not taken into account under Section 14 in computing the undistributed profits tax.)

9. The law gives no specific relief to the corporation which has a deficit which under its charter or under State law would prevent it from paying dividends. The Department holds in T. D. 4674, Article 26-3 (a), that the charter of the corporation is not such a contract as falls within the meaning of Section 26 (c). If this is correct, the tax may be imposed even though the corporation may be legally prevented from paying dividends.

Perhaps such a corporation may be placed in the position where it could legally pay dividends. For example, stockholders, through forgiveness of debt or other proper action, might be able to provide a sufficient paid-in or contributed surplus, or the necessary surplus might perhaps be created through reduction in the par value or stated amount of its capital,—if the State laws would permit.

10. Absence of cash or its equivalent is not recognized as a reason for failure to pay dividends. The Treasury has laid much stress on the possibility of a corporation paying some form of stock dividend which would constitute taxable income to the stockholders. (See Section 27 (e) and T. D. 4674, Article 27-5; also Section 115 (f) and T. D. 4674, Articles 115-3 and 115-4.)

The Department has also laid stress on the possibility of payment of dividends in obligations of the corporation (Section 27 (d) and T. D. 4674, Article 27-4).

How practical such remedies may be is a question. In the case of stock or obligations the dividend credit is limited to the fair market value of the stock or obligations at date of issue. Unless there is a free market therefor, there may be no certainty in advance as to what may later be determined as their fair value. Moreover, unless the fair value of such securities was equal to their par or stated values, the corporation might have to charge its surplus with an amount far in excess of its dividend credit. We must likewise remember that if the corporation issues obligations which it must later pay and the present law continues in effect, it will only be able to meet such obligations by using the profits of a subsequent year or by raising additional capital through the sale of stock, or by contributions from its stockholders.

11. Perhaps no provision of the law is of more interest to accountants than that which allows credit only for the amount of dividends paid within the taxable year. The bill introduced into the House included a provision which permitted dividends paid within two and a half months after the end of the year to be taken into account. This was to allow time for closing the accounts and determining the amount of profits which might be distributed. It was, however, realized that the corporation might receive its dividend credit in one year but stockholders would not be required to take up the dividends as taxable income until the succeeding year, so the law as passed limited the credit to the dividends which were actually paid during the taxable year. The regulations, Article 27-1 (b), hold that "a dividend paid credit can not be allowed unless the shareholder receives the dividend during the taxable year for which the credit is claimed". I think we will have to discover as a result of litigation whether or not the Treasury regulation is correct. Certainly, if the corporation wishes to avoid contest, it will not try to pay a dividend at the last moment but will try to make its final disbursement for the year early enough so that the checks in the ordinary course of the mails should reach the stockholders before the close of the year. In the case of corporations listed on the Stock Exchange this will mean that such dividends must be declared probably before the beginning of December (if the corporation is on a calendar year basis).

Such a corporation, if it is trying to pay during the year dividends equal to the amount of the year's earnings, is apparently faced with making an estimate of what the amount of those earnings will be,—probably on the basis of nine or ten months' actual figures shown by its accounts, supplemented by estimates for the last two or three months of the year.

If the corporation has an ample prior surplus, it may, say in November, distribute an amount equal to the estimated earnings for the year without placing itself in the position of paying dividends out of anticipated profits. From the corporate standpoint it will pay its dividends out of prior surplus, but under the new provision of Section 115 (a) (2) dividends paid during the year are to be considered as out of the earnings or profits of the taxable year without regard to the amount of earnings or profits at the time the distribution was made.

Manifestly, a corporation which does not have a surplus to draw on should not try to pay dividends out of anticipated profits in violation of the

State laws. Possibly, however, it may have a paid-in surplus or may be able, by reduction of capital or otherwise, to create a paid-in surplus from which it might under the State law properly pay a dividend, which dividend, however, would under Section 115 (a) (2) be treated for income tax purposes as a distribution out of the earnings or profits of the year.

I hardly need to say that these questions of corporate surplus and the right of directors to pay dividends, reductions of capital, creation of a paid-in surplus, etc., are all matters for legal advice, and I am only mentioning them to indicate how they fit into the determination of the undistributed profits tax.

12. I can only speak a few words as to the smaller corporations as to which the law gives reduction of tax, viz., corporations with "normal-tax net income" of less than $40,000 or "adjusted net income" of less than $50,000. I have particularly discussed corporations with larger incomes. This is in part because they will presumably demand more of our attention. It may be quite true that to the small business with $5,000 of net income the payment of $805.70 for normal tax and undistributed profits tax is just as serious as the payment of a tax of $31,502.80 by a corporation with $100,000 net income or the payment of $161,280 is for a corporation with $500,000 net income,—which are the total normal and surtaxes each would pay if it made no distributions to stockholders.

The larger corporation can afford to have considerable thought and study given to its situation which the small corporation could not afford. A possible saving, to a corporation with $5,000 income, of $315.70 undistributed profits tax which it could make if it could devise some satisfactory and proper plan for distributing its entire adjusted net income, might not be worth the bother and expense required, whereas the corporation with larger income and a larger amount of tax involved could hardly afford not to try to do this.

Another reason I have been discussing the larger corporate incomes is because it is easier to discuss them. If "normal-tax net income" is over $40,000 we can compute the normal tax at 15% less a flat differential of $1,160 and in tentative computations we could roughly use a 15% rate without particular consideration to the differential. On lower incomes it is probably simpler to make the detail computations. If "adjusted net income" is over $50,000 we can use the general table of rates which I have given. If the adjusted net income is less than $50,000 we must take into account the special credit of Section 14(c), which limits the undistributed profits tax to 7% of the first $5,000 of adjusted net income. I shall not try to discuss the balance of that computation but refer you to T. D. 4674, Article 14-4.

I shall not try to say how far any accountant may feel warranted in trying to give clients a thought and study of their problems which would go beyond any amount which he could expect to charge for it. I would urge, however, that we must beware of giving ill-considered answers to questions which are asked of us. If we cannot afford to give and the client cannot afford to pay for the time and study required in trying to give a right and proper answer to the questions involved, I think we must quite frankly tell

our clients so and not let them feel that we are giving to them thoughtful, well considered answers when we are not really doing so.

13. Estimates of taxable net income will be called for, as I have previously indicated, if a corporation is to see what the amount of its tax will probably be.

If a corporation is satisfied to go ahead blindly, make such distributions to stockholders as it feels readily disposed to do, and then after the end of the year, when it closes its accounts, try to see where it stands with respect to its tax, it will not need to make advance estimates. If it wishes to see before the end of the year where it is probably going to stand with respect to this tax and hopes to guide its dividend policy accordingly, it must make advance estimates. Furthermore, the time now remaining until December 31 is so short that it is probably of vital importance that corporations on a calendar year basis should proceed immediately toward making such estimates.

No corporation can leave this tax situation to the last moment and then hope to have it given adequate and proper consideration.

Here are some of the questions which are going to be involved:

(a) There is not merely the question of what will be the earnings and profits which the corporation will expect to show by its accounts when it closes its books, but there is the question of what will finally be determined as the net income of the corporation by the Commissioner or the courts when they finally determine it.

So we shall have these questions among others to be asked and answered.

Have there been any items during the year whose income tax status will be different from the status accorded to them in the accounts?

Are there amounts for expenses, losses or reserves which have been or will be written off in the accounts but will not be allowed as income tax deductions?

Is the depreciation deducted in the accounts the amount allowable either on the basis the Commissioner has applied in prior years or on the basis which may be applied to this year?

Are there charges for obsolescence, replacements, etc., written off on the books which may not be allowed in the final tax determination?

Are there items of capital losses which will be disallowed under Section 117 (d)?

Are there deductions for bad debts which may be found inadmissable or chargeable to a different year?

Are inventories stated on the income tax basis?

Are there contracts or other settlements taken into the accounts in one year which, for income tax accounting, should be taken into another period?

All of these questions and others must be answered if the taxpayer is to know what his tax will ultimately prove to be. The final determination as to this tax is not to be made on a basis of the accounts shown by the books nor on the basis of the tax return as filed, but on the basis of the determination

which the Commissioner may make, or the Board of Tax Appeals or the courts may determine when the tax accounting is settled two, three or possibly five or ten years from now.

(b) There will probably be questions of administrative policy or business action which would be vitally affected by an understanding of the tax situation; for example:

(1) Suppose a corporation with $100,000 net income sees that at best it will have some undistributed net income which would actually put it into the 22% bracket of the undistributed profits tax. Suppose it is then considering the purchase of $10,000 more of goods instead of distributing that amount of income to stockholders. It finds, however, that failure to pay this $10,000 as dividends would mean a tax of 22% on that additional $10,000 undistributed. Will the profit to be made on such goods warrant paying a tax equivalent to 22% on their cost in addition to paying the normal tax of 15% on any profit thereon?

(2) Suppose, similarly, there are questions of additions to plant, can a corporation afford to make additions and improvements if the use of its funds therefor will mean the payment of taxes of 7% to 27% of the amount which may be thus used instead of being distributed to stockholders.

(3) Suppose a corporation sees that if, instead of using its funds for payment of indebtedness, it uses them to pay dividends to stockholders it may save from 7% to 27% in its taxes. This is going to be one of the worst questions that some corporations will have to decide. Perhaps the payment of $10,000 more as a dividend to stockholders may save a 27% tax on that amount. Will any harm be done if the corporation does pay such a dividend in December and holds off paying $10,000 in bills until it may have further funds in January? Grant that it may be gambling on January results; grant that it may be risking impairment of credit; yet these are questions that the management may have to face and the sooner it faces them the better consideration it can give to them.

(4) If a corporation has a bank loan falling due in December can it persuade the bank to renew that loan so that the corporation might save possibly 27% by distributing $10,000 to stockholders instead of paying it to the bank in settlement or reduction of the loan?

Perhaps one of the important duties of the accountant is to point out how unsound and undesirable from a financial and business standpoint some of the actions are on which this tax law puts a premium.

At this point, let me again emphasize what I have here previously stated, that the use of funds for increased inventories, additions to plants or other proper business purposes will be taken into account in considering whether or not the tax under Section 102 is applicable, but will not be taken into account in computing the undistributed profits tax of Section 14.

(c) The dividend policy may depend on the rate of undistributed profits tax which will be applicable. For example, if a corporation with $100,000 of adjusted net income distributes $90,000, the failure to distribute the final

$10,000 will mean a tax of 7% on the $10,000. However, if such a corporation has made no distributions, its failure to distribute at least $10,000 will cost it 27% of that $10,000. Stated in another way, we can say that if the corporation has distributed $90,000 and is considering whether or not it should try to distribute another $10,000, it can figure that the cost to it of retaining that $10,000 will only be 7% in tax. If, however, the corporation has made no distributions and is figuring on whether or not it might possibly distribute $10,000, it can figure that its failure to distribute that $10,000 will cost it 27% in tax. The 7% for retaining $10,000 may perhaps be considered as simply interest on the money, but 27% is a pretty heavy penalty.

Note here it is not a question of dollar amounts but of percentages of adjusted net income which is involved. So a corporation which has $1,000,000 net income could have $85,000 undistributed without going beyond the 7% bracket of the undistributed profits tax, whereas a corporation with $100,000 net income could only have approximately $8,600 undistributed without passing beyond the 7% rate.

From this standpoint we may note that an error of about 10% underestimate of net income will not prove to be so serious if the corporation has distributed the full amount of its estimated net income. If, however, it has only distributed 40% of its estimated adjusted net income, then any additional net income will run into the 27% bracket.

An interesting table can be prepared to show just how this will work out for various percentages of undistributed net income and such a table will greatly help in trying to consider the practical situation which arises as you or your clients are trying to determine what we might refer to as limits of tolerance of error in making estimates and the importance of trying to distribute any particular amounts.

14. As to the procedure in trying to prepare such estimates, I have found it of value to try to set up for each corporation an appropriate form for stating such estimates. I cannot here try to describe such a form in detail, but I am attaching to this paper as Exhibit "A" a copy of an office memorandum as we have drafted it for our staff and our clients to serve as working instructions with regard to such estimates.

The matter of these estimates is not one with which the public accountant alone can deal. The problems can only be satisfactorily met with the fullest cooperation of the administrative and accounting staff of the corporation.

Consider the situation as it now exists. A corporation may have its accounts closed as of August 31. To prepare an estimate for the year we can at this time have the results shown by the books for eight months of the year to date and must have an estimate for the remaining four months. That estimate should have brought to bear on it the best judgment of the administrative officers as to probable business conditions, probable sales, costs and other expenses of the business, and the resulting estimated profit on the business which according to their best judgment the corporation should expect to earn in the remaining four months of the year.

Each business will have its own factors which should form the basis of such an estimate. Perhaps in one case it may be a basis of tons, barrels or other unit of estimated production. In another case it may be an estimated dollar amount of sales. Whatever may be the basis which the administrative officers naturally use to make their own computations and forecasts, that is the basis which should be applied in making these estimates, because such estimates can only be successfully made as they are made in the way the practical business men think of their affairs even though this may not always be the same way in which the accountant may look at them.

Then, with this best estimate and forecast prepared, there will next come the tying of this in with the usual accounting basis of the books so that as we are considering this case we can add the four months estimated to the eight months actual to get the estimated total for the year. Perhaps the administrative officers will make their estimates without taking into account depreciation. I have no criticism of their so doing if that is the way in which they best reach their conclusions, but if they do this the accountant must see that the depreciation is duly included when the figures are assembled. The same would apply to taxes, interest or any other expenses or charges.

The estimate as thus assembled may probably best be on the usual book basis. Then comes the determination of what adjustments should be made as between the book basis and the income tax basis. Someone should make a careful review of the accounts for the year to see what items they contain which would have a different income tax status from that accorded to them in the accounts. I am not trying to say whether this is work that the public accountant should try to do or whether it is work which can be done by some member of the staff of the client. I would rather have a careful review made by some member of the staff who has a fair idea of the income tax law and what has been done by the Bureau in its audit of prior returns than I would to have the outside accountant attempt to reach some conclusions on a mere cursory review of financial statements but without a full review of the accounts.

I have already indicated that we must consider not merely the adjustments which the taxpayer will expect to make in filing its returns next March, but we must also give some consideration to adjustments which may later be made by the Government in its audit of those returns. All such adjustments must be taken into account not merely as to the period which has been covered by the accounts to date, but also as to the remaining months for which the estimates are made, so that the estimates on the book basis may be converted to estimates on the income tax basis.

Then, if we take into account the dividends which have actually been paid and the dividends which it is estimated will be paid during the balance of the year, we shall have the figures on which to make an estimate of the taxes involved.

I have not taken up a case in this way without finding a multitude of questions immediately arising. The operating men raise questions among themselves as to the basis which should be used for their estimates. Questions may arise between the operating and accounting staffs as to differences

between the basis for operating estimates and the usual accounting basis. A multitude of questions arise as to income tax basis for various items, so that I would supplement the estimates themselves with a sheet or series of sheets on which can be noted the various income tax questions which arise for consideration and decision.

These estimates must be for each corporation as a separate entity. Where an affiliated group exists, operating men, and even financial officers, are apt to consider particularly the consolidated results of the affiliated group, whereas the undistributed profits tax is to be computed for each corporation separately. The fact that some of the affiliated corporations may have had losses is not to be taken into account in determining the undistributed profits tax of the corporations which have net income.

If a parent has a loss and a subsidiary has a profit, dividends paid by a subsidiary may in the parent's accounts be offset by losses of the parent. The subsidiary may then clear its accounts by full distribution of its income to the parent, and the parent may have no need to pay dividends to its stockholders. If, however, the subsidiary has a loss the parent company must nevertheless make full distribution of its own income to its stockholders or else pay an undistributed profits tax thereon.

Also, it must be remembered that intercompany transactions may give rise to a taxable profit to one corporation even though they may not give rise to deductions to another.

Of course, all of this makes a very complicated and involved situation. It is not easy to prepare estimates of this kind; yet the very difficulties involved in trying to do it emphasize the importance of immediately facing the situation that confronts us.

Suppose we now start as indicated with estimates based on eight months actual and four months estimated figures. Perhaps by the time those estimates have been assembled in any reasonably satisfactory shape we shall have before us the September accounts. The question will then be whether with the procedure established and the experience gained in our prior estimates we will be able promptly and satisfactorily to make up a similar estimate based on nine months actual and three months estimate taking into account any changes thus made in estimates of income and any changes due to the answers which will then have been given to the income tax questions raised in making the first estimate. If we can do so we have then laid the right foundation so that in November we can hope to take ten months actual and two months estimated figures to guide us in what may be our final estimates of income as a basis for final dividend action.

If, when we try to make the estimate based on September accounts, we find there are still many questions and difficulties in endeavoring to arrive at satisfactory estimates, we may find that we shall have to work desperately to get these difficulties and questions satisfactorily solved before the date for final action on dividends to be paid within the year.

I cannot try to say how much thought and attention any corporation should try to give in looking ahead to forecast its probable tax situation for

this year. That is a question that the responsible officers of each corporation must determine for themselves. However, I think no one can look at the situation with which taxpayers are confronted under this law without recognizing that no taxpayer can leave his consideration of these tax questions until sometime at or about the end of the year and then hope that he may be able properly to meet the many problems with which he may be confronted.

I realize that I have not been able to lay before you as clear and simple a statement regarding this tax with such easy solutions for its problems as both you and I might have wished. If you have read the law and if you have studied Treasury Decision 4674, you will understand why that was not possible.

I have not fully covered this subject. Mr. Green, who follows me, will add from his wisdom to what I have said, but not all we may say in our discussions tonight and not all that will be said before it comes time for the taxpayers to pay their taxes will fully cover this subject. We have not yet finished in the courts with the disputes regarding the 1917 tax. It will probably be another score of years before we will have settled all the questions which can arise under our present tax law. I have merely tried to mention what seemed to me some of the important points for consideration, particularly as they bear on the need of our taking very seriously the tax thus imposed and the need of trying to forsee, as well as we can, the new and strange tax problems and which it brings upon us.

Current Estimates of Taxable Net Income

EXHIBIT "A"

1. The Revenue Act of 1936 imposes (Sec. 14) a tax on "undistributed net income" which, under Sec. 14 (a), represents the following:

(a) "Net Income"— Sec. 21		$ —
Less—(A) Normal Tax—Sec. 13	$ —	
(B) Interest on certain Government obligations Sec. 26 (a)	—	
(C) Special credit for bank holding company affiliate—Sec. 26 (d)	—	
(D) Special credit national mortgage association—Sec. 26 (e)	—	
Total of above credits		—
(b) "Adjusted Net Income"		$ —
Less—(E) Dividends paid credit—Sec. 27	$ —	
(F) Contracts restricting dividends—Sec. 26 (c)	—	
Total credits against undistributed net income		—
(c) "Undistributed Net Income"		$ —

The exact nature of each of these items is to be determined by reference to the sections of the law which are cited.

Credit items (C) and (D) manifestly will not be applicable to the ordinary business corporation. Items (B) and (F) will only be applicable in particular cases. Item (E) "Dividends paid credit" under Sec. 27 may include various unusual and special items and the provision of Sec. 27, taken in connection with Sec. 115, may serve to exclude certain amounts which otherwise might be considered as dividends. While it may be necessary in any particular case to check carefully to see which, if any, of these special conditions or limitations may apply, it will be generally assumed, in the following discussion, that in the ordinary case we are dealing with a corporation where—

net income, less normal tax = adjusted net income

and—

adjusted net income, less dividends paid =
undistributed net income.

However, it is understood that if any other items are present in any case, they should be duly taken into account.

The primary factor in this computation is to be the "net income" for the year in accordance with which the corporation files its income tax returns. For most corporations, this is the calendar year. In other cases it may be a fiscal year. For the purposes of this memorandum it will be assumed that the corporation reports its net income by the calendar year.

The net income is to be the net income as determined under the Revenue Act of 1936 which may be, and in many cases is, different from the income which is shown in the ordinary accounting reports of the corporation.

Particular attention should be given to (a) any differences in the depreciation which is charged in the corporate accounts and that which is allowable for income tax purposes; (b) any items of "capital net losses" as these are defined in Sec. 117 of the Revenue Act, which are treated as deductions in the ordinary corporate statements, but may not be deductible for income tax purposes.

Dividends received from other corporations are to be included in net income to their full amount. Only 15% of the amount of dividends from domestic corporations will be subject to the normal tax, but their entire amount will be included in undistributed net income to be used as a basis for figuring the undistributed profits tax. The normal tax is deductible from net income in the undistributed profits tax computations. The basis on which inventories are carried in usual corporate accounts may not be the same as the basis allowable for income tax purposes.

As to other items, there may also be particular adjustments which should be made to bring the amount of income stated in the usual corporate income statements to the amount which would be "net income" for income tax purposes.

2. Under the new Revenue Act it becomes essential that the corporation should consider what will be the amount of its "net income" for the year which, if not distributed in "dividends paid during the taxable year" (or covered by other special credits of the law), will be subject to the undis-

tributed profits tax which may run from 7% to 27% of the "undistributed net income".

To this end serious endeavor should be made by each corporation to estimate currently as nearly as it can what will be the amount of its "net income" for the year because it cannot wait until the amount of that net income is determined after the end of the year and then make dividends to be taken into account in the computations of its undistributed profits tax. The following procedure is accordingly recommended.

3. As soon as the accounts are closed after the end of each month, a statement should be prepared which would show the "net income" of each corporation which has been realized or accrued for the ———— months to date. This should show the "net income" figure supplemented by a reconciliation with the amount which is shown in the usual corporate statement for that period. The net income should be placed as nearly as possible on the basis which it is believed will be determined upon as representing the "net income" for income tax purposes.

It will be a matter of judgment of how much detail should be set forth, but, in any event, the amount of dividends received from domestic (U. S.) corporations should be separately stated.

This statement for the ———— months to date which have been covered by the accounts should then be supplemented by the best estimate possible of the "net income" to be realized or accrued for the remaining months of the year similarly stated and reconciled with the estimate of income according to the usual corporate method of statement.

The two figures, the actual for the ———— months to date and the estimate for the remaining months of the year, should then be added into a further column (or columns) to give the then estimated total for the year.

On this sheet or a supplemental sheet, there should then be made a computation of the estimated taxes on the basis of the net income, partly actual and partly estimated, as outlined. The normal tax will, of course, be figured on the amount of net income less credit for 85% of the dividends from other domestic corporations. The undistributed profits tax should be computed on the estimated net income less the estimated normal tax and less an amount of *estimated* dividends for the year (which may well be broken down to show the amount of dividends paid during the ———— months to date, plus an estimated amount to be paid during the balance of the year).

It is here contemplated there would be no showing of excess-profits tax although that should be taken into account, if it appears that the amount of the declared value of the capital stock is not sufficient to give the full exemption. It is understood that the entire amount of the capital stock tax would be deducted in computing "net income".

Needless to say, if there are other special credits or allowances which the law permits to be taken into account, these would be duly recognized in the computation.

4. If this procedure is followed month by month, the corporation will then have a series of partly actual and partly estimated figures before it by

which it can guide itself in determining its policy as affected by the new undistributed profits tax.

For example, if this procedure were started as soon as the June 30th statement is prepared, then sometime during July there would be a statement for each corporation which would show an estimate for the year based on six months actual and six months estimated figures. In the latter part of August there would be the statement with seven months actual and five months estimated figures. Then in the latter part of November there would be the statement with ten months actual and two months estimated.

Bearing in mind the fact that any dividends to be taken into account in the undistributed profits tax computation must have been *paid* within the year, and assuming that there would be some period which must elapse between the date of declaration and date of payment of the dividend, it will be seen that such a statement as this, covering only earnings to the end of October and estimated earnings for two remaining months, would be about the last statement to which much consideration could be given before the date on which it would be necessary to make the final dividend declaration for the year. (Of course, the matter should probably be checked up to the latest possible date, but this could certainly be more intelligently and better done following such a series of monthly estimates as are here recommended).

There are two reasons for suggesting that such statements should be made currently month by month—

(a) When the first of such estimates is prepared and is considered, it is likely to disclose various matters which call for special consideration. There may be matters whose income tax status should be promptly determined so as to avoid, as far as possible, uncertainty and confusion at the end of the year. There may be questions of finance to consider if full distribution of income is to be made. The consideration of such a statement may possibly influence the rate of the then current dividend declaration without waiting for the entire amount to be an adjustment in a final declaration for the year.

(b) In figuring items month by month in this way, there should be a much closer approach to the estimate of "net income" for the year by bringing out the differences between the usual estimates of operating earnings and the statutory "net income" of the income-tax law, and getting those who make up these computations, as well as those who make the estimates, accustomed to taking both features into account.

Heretofore, the question of advance estimates and exact earnings has not been of such great importance for income tax purposes because there was a flat rate of tax which had to be paid regardless of what disposition was made of the income after it was earned. The present undistributed profits tax makes important the question of what, if any, disposition is made of the net income and no sound policy as to disposition of net income can be determined upon except on the basis of reliable estimates of what will be the amount of the net income.

Accordingly, this plan for making current estimates of total "net income" for the year is recommended in the belief that as a general matter they will

be worth the time and effort required for their preparation and study. This is true not merely as to any time of the accounting staff in preparing such statements, but also as to the time of executive and administrative officials in making the most reliable estimates possible of the probable income for the balance of the year. The complications and involvements of the new law are so great that if they are not promptly faced the corporation may find itself at the end of the year subject to heavy penalty taxes.

5. The Forms A and B are drafted to illustrate, simply and in a general way, how such statements might be presented, but understanding, as previously stated, that it will be a matter of judgment as to how much detail it may be considered advisable to give in such a series of statements.

Since each corporation is separately taxable (except only as consolidated returns are permitted for railroad corporations), manifestly these statements should be prepared for each corporation separately. Where there are a number of corporations which customarily publish a consolidated statement, it may then be desirable that these separate statements should be consolidated, with elimination of intercompany profits, etc., so as to show how these separate estimates compare with any other estimates which may be made of consolidated net income. This may be a desirable check on them, but no consolidated statement can of itself give the basis for determining the taxes which each separate corporation will have to pay.

The statement of "net income" may either start with a statement of the statutory net income for income tax purposes and then give the reconciliation to bring it to the corporate income or loss as usually stated in the accounts; or may start with the usual form of corporate statement and then show the adjustments to bring this to "statutory net income". The latter method is followed in the Form A attached since this will probably be the simplest manner of preparing the form in usual practice. If adjustments between the book figures and those for income tax are numerous, it may be desirable to have these set forth on a separate detail sheet and then summarized on Form A.

FORM A

______________________ CORPORATION

ESTIMATE OF NET INCOME

For the Year ____

	____ Months to date per accounts	____ Months balance of year estimated	Total for year
1. On usual accounting basis per books			
Income from operations	$ —	$ —	$ —
Other income:			
Dividends from U. S. corporations	—	—	—
Sundry	—	—	—
Total	$ —	$ —	$ —
Sundry deductions	—	—	—
Net profit on book basis	$ —	$ —	$ —
2. Adjustments to income-tax basis			
Additions:			
Federal income tax accruals	$ —	$ —	$ —
____________	—	—	—
____________	—	—	—
____________	—	—	—
Total additions	$ —	$ —	$ —
Deductions:			
____________	$ —	$ —	$ —
____________	—	—	—
____________	—	—	—
____________	—	—	—
Total deductions	$ —	$ —	$ —
Net additions or deductions	$ —	$ —	$ —
3. "Net income" for income tax	$ —	$ —	$ —
4. Dividends paid	$ —	$ —	$ —

Dated __________ 193__

NOTE: The foregoing is an illustrative form, with the understanding that items will be stated in such form, arrangement and detail as may seem desirable in any case.

FORM B

____________________ CORPORATION

ESTIMATE OF FEDERAL INCOME TAXES

For the Year ____

1. *Normal Tax*

Net income—per Form A		$ —
Less—85% of dividends received—Sec. 26 (b)	$ —	
____________	—	
Total credits		—
Normal tax net income		$ —

Normal Tax Computation—Sec. 13:

8% on first $ 2,000	$ —	
11% " next 13,000	—	
13% " " 25,000	—	
15% " balance	—	

(If normal tax net income is more than $40,000 the tax can be figured by deducting $1,160 from 15% of the normal tax net income.)

Normal tax		$ —

2. *Undistributed Profits Tax*

Net income—per Form A		$ —
Less—Normal tax, as above	$ —	
____________	—	
Total of above credits		—
Adjusted net income		$ —
Less—Dividends paid—Sec. 27	$ —	
____________	—	—
Undistributed net income		$ —

Undistributed Profits Tax Computation*—Sec. 14:

First	10%	of Adjusted net income	$ —	@	7%	$ —
Next	10%	" " " "	—	"	12%	—
	20%	" " " "	$ —	"	9½%	$ —
Next	20%	" " " "	—	"	17%	—
	40%	" " " "	$ —	"	13¼%	$ —
Next	20%	" " " "	—	"	22%	—
	60%	" " " "	$ —	"	16⅙%	$ —
Next	40%	" " " "	—	"	27%	—
	100%	" " " "	$ —	"	20½%	$ —

3. *Total Estimated Normal and Undistributed Profits Tax*

Normal income tax	$ —
Undistributed profits tax	—
Total normal and undistributed profits tax	$ —

* This form gives the cumulative average rates so as to avoid, as far as possible, the detailed computations. For example, if undistributed net income is 45% of adjusted net income, the 40% amount can be taken @ 13¼% and the 5% amount @ the 22% applicable to the next higher bracket.

The Tax on Undistributed Profits Imposed by The Revenue Act of 1936

By Edward H. Green

At the outset, before discussing the Act, I would like to say that I agree that it is an exceedingly inadvisable one. I think it is bad for the reasons that have been mentioned and discussed heretofore. Perhaps I think the Act is inadvisable chiefly because it makes it difficult for small and new companies to grow out of profits.

It may be noted, also, that this tax bears more harshly on a corporation on an accrual basis than on one on a cash basis, and most corporations are, and of necessity must be, on an accrual basis.

If I had my way the statute would never be on the books, and, once on the books, I would take it off immediately. I say that so as not to be misunderstood because, once having passed by that, I am not going to let my views as to the wisdom of the legislation enter into my consideration of the meaning and validity of the statute. You cannot go into those questions having the bias that you believe it to be an unfair tax or an unjust tax; you should only approach it from the angle that you have nothing to do with its unfairness or unjustness—there it is. I must therefore take an objective approach to the statute and consider it in that way. I first gave you my view as to its merits simply because, when I take my objective approach to it, I do not want to be misunderstood by anyone as believing that it is a wise tax.

I think that in considering the tax, the first thing we have to remember is that, popularly, it has been called an undistributed profits tax; that is just a misnomer. Unless you forget that misnomer, you are going to have difficulty in really getting the scheme of the statute and an understanding of what it is all about. From the legal standpoint, it is not a tax on undistributed profits; that is a short-cut expression and is an attempt to describe in a few words the tax you are talking about, but do not try to build any conclusions about what the tax does or does not do from that name. It is a surtax on net income, which is measured by a statutory formula. The formula starts with ordinary net income and makes certain adjustments and one of these adjustments is the deduction of the amount of dividends that corporations pay. Legally it is just that, and nothing else; it is a surtax on net income.

The approach to it is that the government needed more money and decided that one of the sources for additional tax was the profits that were being made by corporations. It determined to impose a surtax on those profits in addition to the regular tax, and then it took the position that it did not much care who paid that tax, the corporation or the stockholder, so long as it received additional revenue from corporate profits. It said to the corporation: "Primarily, you pay it; however, if you distribute the profits to the stockholder so that the stockholder pays the tax, it is satisfactory to us. Either way we have additional revenue from corporate profits."

Presented at a special meeting of The New York State Society of Certified Public Accountants on September 21, 1936.

At first this seems a novelty, but in reality it is not unprecedented. We have a situation just like that in the existing tax law and we have had it for quite a long while. We have it in estates in the process of administration. The executor has income and while the estate is in the course of administration if he pays some of that income to the beneficiaries, the beneficiaries pay a tax on that part of the income; if he does not distribute it, he pays it himself. If the estate has a net income of $50,000 and the executor pays $20,000 to beneficiaries, then the executor pays a tax on $30,000. In a sense that is an analogy to what you have here. Congress wanted to tax the income of estates in the course of administration; it put it primarily on the executor, but gave him a deduction for what he passes on to the beneficiaries. Here the Act places it on the corporation, but relieves the corporation to the extent that it passes the income on to the stockholders.

If you keep that approach in mind, the scheme of the statute will start to develop, and it will prove of assistance in solving some of the problems. Obviously, the first thought is that, if the corporation is to be relieved from paying a tax on the profit, it has to pass that profit on to the stockholder in such a way that the stockholder pays a tax on it. Otherwise, the scheme would be pointless; there would be no reason or logic back of the statute.

Accordingly, it is provided that if the corporation pays a non-taxable stock dividend to its stockholder, it gets no credit. This seems entirely reasonable and logical. If the stock dividend is not taxable, the stockholder pays nothing.

Let us take up the next point: How about distributions and liquidations? This is covered by the statute in two subdivisions which some people find difficult to reconcile. I find no particular difficulty in reconciling them. In Section 27, Subdivision (f), it says that if a payment in liquidation is chargeable to earnings it is a credit. It seems entirely logical that should be so because, generally speaking, if the distribution in liquidation is chargeable to earnings, then is it taxable to the stockholder; and if it is taxable to the stockholder, it logically follows it should be a credit to the corporation.

Then we come to Subdivision (h). This says that if the distribution is not taxable the corporation gets no credit. Again, that is perfectly logical, and carves an exception out of the proceeding subdivision. The rule is stated correctly, I think, that ordinarily if the distribution to the stockholder on liquidation is chargeable to earnings it is taxable to the stockholder, and therefore it is a credit to the corporation. However, this year Congress has put into the tax law a provision which is the well known 112-(b)-6, which provides that a subsidiary can be completely liquidated and the parent can take over all of its assets without any tax at all. There you have a liquidation in which the subsidiary turns everything over to the parent, including that which would ordinarily be charged to income, and still the statute says expressly that none of it shall be taxable to the parent company, that is the stockholder. It would seem logical, therefore, if we carry through

our analysis of the scheme of the statute, that the paying corporation ought not to get any credit as a result of that distribution.

That is exactly what I understand Subdivision (h) means when it makes the blanket statement that, if the distribution is not taxable to the stockholder, then the corporation gets no credit. It seems to me that the line runs right through the statute—runs through it carefully and logically—tax to the stockholder, credit to the corporation—no tax to the stockholder, no credit to the corporation.

If I may digress here just one moment, I would like to say that, as a result, if any of you are working on a plan by which a subsidiary is to be dissolved and its assets are to be taken over by the parent under the provisions of Section 112-(b)-6, I want to remind you that you ought to have it first pay out as a dividend so much of its net income for the year as was not theretofore paid out. I think that if you do not, the Treasury will claim that the subsidiary which has been dissolved will have to pay the surtax measured by those undistributed profits.

Again, we get the question of so-called "deficit corporations", that is, corporations with a deficit in the surplus account. If our analysis is correct, there is no logical reason why this surtax should not be applicable to them. The Federal income taxes are based on the income of an annual period. They do not go into the question as to whether the stockholder is rich or poor, whether he has large assets or small assets or what they are in relation to his liabilities; they say that if a taxpayer has income as defined within the taxable year, he pays his tax on it. This is routine with respect to the normal tax. The corporation that makes money, even if it has a surplus deficit, has to pay a normal tax on its net income; and there is no logical reason why, if a corporation's assets do not exceed its capital stock and its liabilities, it should not pay the surtax.

I am not talking about fiscal policy, or what we think is sound judgment rather than strict logic. Congress has seen fit not to exercise its discretion in favor of the corporation with a deficit in its surplus account. If a person talks about hardship, it is just a difference in degree and not in kind; it is a hardship for a company which has a deficit—that is "in the red", as we say—to have to pay the normal income tax on the money it makes. The same result would have been reached if Congress, instead of imposing the surtax, had merely increased the normal tax, as the method of getting additional revenue from corporate earnings.

You may say that the corporation that has a deficit cannot pay out any dividends, and thus cannot get the deduction. Let us approach that in cold blood. For the normal income tax, Congress has provided quite a number of deductions. If a corporation cannot meet the circumstances to get those deductions, it is "just too bad." Congress, in the normal tax, said: "If you pay any interest, you can deduct the interest from your income". If you have no debts, you have no interest to pay and you get no deduction. If a company was financed by an issue of preferred stock, it does not get the interest

deduction. If the company got the same amount of money by putting out a bond issue, it does get the deduction.

I think we are all more or less inured to the fact that Congress has bestowed its deductions and its credits in a more or less reasonable or unreasonable way, and that the taxpayer either comes within them or does not. If you are so unfortunately placed that you cannot pay a dividend, you cannot get a credit. It may be too bad, but a man that does not own any real estate does not get the deduction for real estate taxes.

Next, our analysis brings us to the question of when must the dividend be paid. As our Government runs its fiscal affairs upon the basis of an annual accounting period and puts all its taxpayers upon an annual accounting period, logic would require that this tax should be paid either by the corporation or the stockholder in the same accounting period; therefore, it follows that, for the corporation to get the deduction, it must bring it about that the stockholder pays the tax for the same corporate period that the corporation would have paid it. Otherwise, the Government's budget calculations would be upset. If a corporation for 1936 makes a certain sum of money and the Government says that, instead of asking it to pay a tax on that sum of money, the Government will relieve it of the tax on so much of the income as is passed on to the stockholders, it would seem to me to require that the stockholder who gets that income should pay the tax on it in the same period that the corporation would have paid the tax if it had kept the income itself. If the dividends from 1936 profits were not paid out to the stockholder until January or February, 1937, the Government would not get its tax on it until 1938. Hence, you find the provision that in order to get the credit for any tax year, the tax must be paid by the corporation in the same tax year.

That brings us to our next problem. The statute says that the dividend must be paid within the same year. The usual way to pay dividends is for the corporation to mail a check. The regulations recently issued say this means that the check must be mailed in time so that in the ordinary course of the mails it would be received within the year by the stockholder.

That probably is a rough and ready rule of thumb which appealed to the administrative mind as being a workable rule. It is difficult, however, to find any logic in it. You can approach it several ways; you can start off by saying that the dividend is not paid when the check is sent or received; that the dividend is not really paid until the check has gone through the bank, and then the dividend has been paid. Whatever may be said as to the logic of that rule, I think it is so unworkable, as a practical matter, that the Government will not seek to adopt it.

So we come back to the other theory and assume that the Treasury will recognize what has become a financial and commercial custom, namely, that the check itself is regarded as payment. If that is so, it seems that a strong argument can be advanced to the effect that when a stockholder becomes such and gives the corporation his postoffice address, he impliedly, if not expressly, says to the corporation: "Anything that you want to send to me, mail to that address". If that is a fair construction, then it would seem that

when the corporation puts the check in the mails "postage prepaid" and addressed to that address, it has delivered the check to him as he has requested, and that the act of mailing could be treated as payment of the dividend by the corporation.

Perhaps another approach that brings us to the same conclusion is that the stockholder receives the dividend when it is unqualifiedly made available to him. If a corporation declares a dividend payable on December twenty-ninth, that dividend is subject to the demands of that stockholder on that day. The only reason why he does not get it on December twenty-ninth is because he has told the corporation to do something with it which, as a result of his instructions, does not allow it to reach him until later. It seems to me that there is a strong argument that the dividend has been paid to him on that date; from that date the dividend is unquestionably a liability of the corporation; if it does not pay it, the corporation can be sued for it, and on that date every single stockholder in the corporation could have that dividend. For that reason, I am inclined to feel that, if the question gets into the courts, there is a strong probability that the Treasury regulation will not hold. However, the regulation is there, and naturally the wise course is to tell your clients to make every effort to get the dividend check into the hands of the stockholder before the end of the year. I am raising the other arguments merely because, if some of your clients have failed to do so and a revenue agent asserts the tax, I do not think it is absolutely necessary for you to tell your clients to throw up their hands.

I want, at this point, to say a few words on the question of the constitutionality of the tax. I have analyzed it first because I think that that is important in determining the question of its validity. I suppose there are few questions that any lawyer approaches with so much diffidence as the problem of constitutionality, but, fortunately, we do not have quite as much difficulty when we talk about Federal income taxes. The limitations on Congress in imposing income taxes are really very few, and since the Sixteenth Amendment has been passed the Supreme Court of the United States has held invalid very few provisions of the Federal income tax laws. Please remember that the Sixteenth Amendment authorizes Congress to lay a tax on income, not merely on net income; and that the courts do not hold that deductions are a matter of right, but rather a matter of grace.

We have had many provisions in the past which I think have been as arbitrary as the statute we are now considering. If you will remember, the excess profits tax was based upon an invested capital, and some of the limitations as to what was to be included therein were about as arbitrary in their results as this statute. We have had limitations on the amount of interest that could be deducted. We have today limitations of losses on the sale of capital assets, which bring about some absurd results. Many other examples will occur to you.

Some people say that this statute is bad because Congress cannot base a tax on the use to which the income is put. But this is not a tax based upon income depending on the use to which it is put; it is a tax on income, and the

option is given as to who is going to pay the tax, the corporation or the stockholder. It has been said that this is really not a tax at all but a penalty to force distribution, and that Congress cannot do that. I do not think that this is a tax for failure to distribute; whether the corporation distributes or not is a matter for it to determine as the result of a great many considerations. We had a somewhat similar situation when Congress recently imposed a tax on dividends received by a corporation; that tax has made it more expensive to be a holding company, but the Act is not invalid on the ground that it is a penalty to force holding companies out of existence. Similarly, at various times it has been more expensive to be a corporation than a partnership, or vice versa, but that does not mean that Congress has imposed a penalty in any constitutional sense.

Again, it is said that Congress, in not making exceptions for companies with deficits, is putting pressure on them to violate the laws of their state which prohibit them from paying dividends unless they have surpluses. It does not seem to me that this is legally sound. Congress has given corporations a deduction if they come within a certain set of conditions. I do not think that here, any more than any other place in the tax law, you can say Congress is urging or putting pressure on corporations to violate the state law if any particular corporation can not come within the set of conditions except by violating the state law.

It is commonly said that this tax is arbitrary, and I agree with that. But it seems that the arbitrariness is not a legal arbitrariness—that Congress has been consistent in saying that it was imposing a further tax on corporate profits and leaving it to the corporation, through its own chosen directors, to decide whether the stockholders or the corporation itself would pay it.

It has been said that this tax is really like the child labor tax which the Supreme Court held to be unconstitutional. What Congress provided there was that the person who employed child labor paid an extra tax. Now, it is quite obvious that that was not in reality a tax statute. What the Government wanted you to do was to stop employing child labor, which would result in no tax—that was a statute to make you do something in order to avoid a tax. Of course, that is not the case here—either the corporation or the stockholder must pay. The Treasury get its revenue in either case. Thus, we have a true revenue raising statute.

It may be that further reflection will cause some of us to have other views, but at the present time, however much I dislike the statute, I cannot believe that the Supreme Court is going to hold it unconstitutional. Therefore, I think that the safe course for you to pursue is to prepare to comply with it.

Now, I want to say something about the credits. Naturally, there is no problem if the dividend is paid in cash, and there is not very much of a problem if the dividend is paid in property. In the latter case you have to remember that the corporation gets a credit either on the basis of what the property is worth at the time of distribution or what the statutory base of that property is to the corporation, whichever is less.

I should remind you that the justification for the statute offered by some of the people that sponsored it is this: a corporation should pay out its earnings; and then, the stockholders, after receiving the dividends and paying the tax thereon, can put the balance back into the corporation, if they are so minded; that is the way they believe the corporation ought to finance itself and grow—through the volition of the stockholders, rather than through withholding the profits. There may be some superficial plausibility to the theory, but I think its practical weaknesses are many and apparent.

I said a few minutes ago that a stock dividend is not a credit unless it is a taxable stock dividend. One uncertainty as to the taxability of stock dividends was ended by a decision of the United States Supreme Court last spring. That Court seems to have laid down a rather simple and workable rule, that is, that if the stock dividend does not change the proportionate interest of the stockholders, it is not taxable; otherwise it is taxable. It seems practical, and you should have it in mind.

This leads me to point out that this statute suggests in this connection something which is quite new, namely, the optional stock dividend. The statute provides that if a corporation declares a dividend giving the stockholder the choice of whether he will take it in cash or in stock, and if he decides to take it in stock, it is a taxable dividend. Obviously, if he takes it in cash, it is taxable to him, and the corporation gets the credit; in addition, the corporation gets the credit if he decides to take it in stock. I am bringing that to your attention because it may help to solve the situation in which some of your clients may find themselves. A corporation may have made a hundred thousand dollars. It may need that money very badly in its business; it may even need the money so badly that payment of the tax on it would be unfortunate. Now, if it has a small, or comparatively small, body of stockholders, it can go to the stockholders and say: "What we will do is to declare a dividend, optional with each of you as to whether you will take cash or stock, provided you will indicate to us in advance that you intend to take the stock". If the situation is a proper one, the stockholders may say: "We intend to take the stock". In that case the corporation can declare the optional dividend and keep its cash, and at the same time get the full credit and pay no surtax. The burden, of course, is upon the stockholders, because they will then have to pay an income tax upon the stock they receive. However, the corporation may be able to satisfy its stockholders that this is the advisable course and in their best interest.

I want to say a word of caution about this: The question has been raised that this may violate the provisions of Section 27 (g). Now, a word as to 27 (g). Congress has provided that a dividend paid by the corporation is not a credit unless it is paid pro rata to all stockholders of the same class. I think that if you have given every stockholder in the same class the same option—if every common stockholder is given the option to take one dollar or a tenth of a share of stock for each share that he owns—you have treated all stockholders of the same class alike, regardless of what election each one makes.

I should add just a few words on the matter of contracts restricting the payment of dividends. You will probably note that the statute provides a credit where the dividend payment cannot be made without violating "a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends".

At once a question arises as to whether or not these words include a corporation's own charter, which might, for the benefit of the preferred stockholder, provide that it could not pay dividends on the common stock under certain conditions. The question is obviously one of doubt, and will eventually be settled by the courts. The Treasury says the answer is "no; a corporation charter is not a contract within the meaning of this provision"; and, if you want my own personal view, I am inclined to believe the Treasury will be sustained. It seems to me that while it is true that, in a strictly legal sense, a corporation charter is a contract between the corporation and the sovereign on the one hand and between the stockholders themselves on the other, I doubt that Congress when it used that language — "a written contract executed by a corporation prior to May 1, 1936 containing a provision which expressly deals with the payment of dividends" intended to include a corporation charter. For one reason, the question was very much pressed upon Congress, and I believe the legislative history will show that Congress was urged to make express provision to meet such a situation. Also, if you say that, technically, a charter is a contract, I say that, technically, a corporation does not execute its charter, and it does not sign it. Some people say that "executed" does not mean "executed" in the sense of writing, but that the phrase was directed to the date on which it was entered into. The argument is that the phrase should be construed as though it read "a written contract entered into prior to May 1, 1936". It would seem to me that Congress could have used so many general expressions that would have clearly included restrictions contained in a corporate charter, that we must give full weight to the fact that it used such carefully limited language.

I also call to your attention that a credit is given for earnings and profits required to be paid or set apart for payment within the taxable year in discharge of a debt, when this is required "by a provision of a written contract executed prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits for the taxable year". You should note carefully the limitations in the language. If a corporate mortgage merely requires the corporation to retire a percentage of its bonds every year, it gets no credit, even though the retirement is out of profits. If the corporation must retire an amount of bonds based upon a percentage of coal mined or trees cut, it gets no credit, because the requirement is not expressed in terms of earnings or profits. If it is required to apply a certain percentage of its net earnings or profits to the retirement of its bonds, then it is entitled to a credit—of course, if the other conditions are met.

The corporation can get only one deduction on this account. It may have a half dozen different contracts restricting the payment of dividends or

dealing with the disposition of its profits, but it gets a credit under only one of them; but fortunately it gets the credit which is the largest one.

You are going to have some other difficulties. Suppose you had a contract provision that a corporation must not pay any dividends on its common stock unless its assets are twice its liabilities. That means that every day for three hundred and sixty-five days of the year, you have to check up and see that the assets did not exceed the liabilities by that margin on any day, in order to get the credit. It seems the Treasury will have to work out some practical way to apply such provisions. Theoretically, if there is any single day in the year on which the assets exceed the liabilities by the necessary margin, a dividend could be paid on that day without violating the contract.

There is a carry-over provision which provides that if a corporation in any year pays out dividends, and it turns out that the dividends paid out were more than the amount of its adjusted net income, then it can carry the excess over to the next year and take that excess as a credit in the next year; provision is also made for carrying the excess over to the second succeeding year. That is a useful provision, but I must caution you that if in determining how much the corporation must pay out in dividends it has taken advantage of a credit based upon a contract restriction, or a sinking fund provision, that credit must be deducted in computing the carry-over. If a corporation's profits were $100,000 and it got a credit of $30,000 because of a sinking fund provision, leaving $70,000 to pay out, and it paid out $80,000, it does not get a carry-over credit. An excess created in that way may not be carried over.

I must also call your attention to the fact that, where you have a consolidated corporate group, this problem must be considered separately as to each subsidiary and separately as to the parent. Obviously, an orderly procedure would be to take up the problem with each subsidiary first and decide what each subsidiary is going to do, because you cannot know what action the parent company should take until a decision has been made by each subsidiary as to what dividend it is going to pay the parent.

Finally, I want to urge you as strongly as I can to take this statute up promptly with every corporation whose affairs you are handling. The problem is a complicated one. Sometimes there is nothing you can do about it — but, in a large number of cases there is something you can do if you take up the problem and consider it in time. It just will not do to let your consideration of these problems wait until December. It is worthy of your very best care, and I think you will be doing a very great service to your clients if you persuade them that this is something that cannot possibly be taken up too soon for study.

Some Questions and Answers on the Surtax on Undistributed Profits of Corporations Imposed by The Revenue Act of 1936

Answered by HENRY B. FERNALD

QUESTION: In Article 26-3 (b)* Example 1 states net income of $200,000 but earnings and profits of the taxable year, before deducting Federal income taxes, of $210,000. Example 2 states adjusted net income of $162,660, plus normal tax $27,340, representing a net income of $190,000, but current earnings and profits of $140,000, before deducting Federal income taxes. Why is this difference between "net income" and "earnings and profits of the taxable year, before deducting Federal income taxes"? Is it correct to assume that earnings and profits mean the net earnings and profits as shown by the books of the Company before deducting Federal income taxes and also before eliminating any tax-exempt income or any unallowable deductions?

ANSWER: I think "earnings and profits" as used in the examples in Article 26-3 (b) undoubtedly has the meaning attributable to that expression as used in Section 115 (a). Congress has never defined that exact meaning. Courts seem to differ about it. The Treasury Department seems quite uncertain about it. Article 115-1, Regulations 86, states that "among the items entering into the computation" are "income exempted by statute", etc., but that gains and losses under Section 112 are to be included "at the time and to the extent" there recognized. *Wells Fargo Bank and Trust Company* v. *McLaughlin* (8 F. Supp. 1009) approves using the depreciation as allowed by the Commissioner as an income tax deduction to the corporation rather than the amount shown by the books.

So, in Example 1, the corporation might readily have $200,000 of net income but $210,000 of earnings and profits before deducting income tax, if it had $10,000 of tax-exempt income. In Example 2 the corporation might have $190,000 of net income but only $140,000 of earnings and profits before deducting income tax, if it had $50,000 of capital losses disallowed by Section 117 (d).

In this connection, let me point out a question which I think will only be settled by litigation. Assume a corporation was formed this year which in its first year had $100,000 of net income but $100,000 of capital loss disallowed under Section 117 (d). It has then no earnings or profits. Even though it had a paid-in surplus from which it could, under State law, make a distribution to its stockholders, such distribution would seem not to be a "dividend" within the meaning of Section 115 (a). Apparently, if it made such a distribution out of paid-in surplus, it could get no credit in computing undistributed net income under any of the provisions of Section 27, unless we can extend Section 27 (f) to mean that such a distribution might be considered as "properly chargeable to the earnings or profits accumulated" as they stood before taking into account the disallowed capital

* References herein, unless stated to the contrary, are to Sections of the Revenue Act of 1936 and to Articles of the Regulations T. D. 4674.

Presented at a special meeting of The New York State Society of Certified Public Accountants held on September 21, 1936.

net losses. This seems a very strained construction; yet the result otherwise seems so grievously unjust to the corporation that I cannot help wondering if we may not possibly have some such interpretation given.

QUESTION: Article 27-8 gives two examples in which one or more of the stockholders make their returns on the basis of a fiscal year ending July 31 but, nevertheless, the corporation is entitled to its dividends paid credit with respect to the dividend paid on July 15. Are there any conditions under which, because of the difference in the fiscal year of the stockholders and that of the distributing corporation, the amount of dividends paid credit would be affected?

ANSWER: I can think of no such conditions. The regulations do, rightly or wrongly, in Article 27-1 (b) hold that a dividend is not to be considered paid until it is received by the shareholder. There is no requirement as to what may be the taxable year of the corporation and of its stockholders. In the examples given, the dividend is stated to have been paid on July 15. This is a dividend paid by the corporation within its calendar year and the corporation seems entitled to credit thereon, regardless of whether or not its stockholders file their returns by calendar or by fiscal years.

QUESTION: A corporation has $50,000 income in 1936 but pays no dividends in that year and accordingly pays a surtax on undistributed net income. If the corporation later distributes part of this income on which the undistributed profits tax has been paid, is the stockholder fully taxable thereon?

ANSWER: The fact that the corporation may have paid undistributed profits tax on the earnings of any year does not grant any exemption to the stockholders when such earnings are later distributed. The stockholder will have to pay his full tax on the amount of dividends paid to him regardless of any undistributed profits tax the corporation may have paid thereon.

Answered by EDWARD H. GREEN

QUESTION: Article 26-3 (b) of T.D. 4674, which relates to "prohibition on payment of dividends", gives two examples of computation of the "credit allowable". In both of these examples, the Commissioner adds to the "aggregate of the amounts which can be distributed" the earned surplus at the beginning of the taxable year. A reading of Section 26 (c) of the Revenue Act of 1936, which these examples and regulations refer to, does not disclose any direction to apply the earned surplus at the beginning of the year to the payment of dividends or amounts which can be distributed. That section appears to refer to the "adjusted net income" for that year only. Would you consider the inclusion of the earned surplus for prior years in such amounts which can be distributed an arbitrary determination of the Commissioner without any authority of law?

ANSWER: I think some of the premises in that question are not entirely sound. It is true that, in determining the amount upon which the so-called "Undistributed Profits Tax" (which I prefer to call the Surtax) is based, you look

only at the income for that year. To determine that, you do not look at the earned surplus existing at the beginning of the year. However, when you come to seek the benefit of a credit because of a provision in a contract which restricts the payment of dividends, then you have a different situation. The statute reads this way: ". . . an amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends". Now if, under the terms of that contract, you are not prohibited from paying a dividend out of prior earned surplus then, says the Treasury, you do not bring yourselves within the provision. Thus, for example, if you are prohibited from paying a dividend unless your surplus is $50,000, and if you made $50,000 in the year 1936 but you started the year with a surplus of $10,000, you can pay a dividend in 1936 of $10,000 without violating that provision of your contract because you had $10,000 to start with and you had $50,000 more during the year; that gave you $60,000. Your contract required you only to keep a surplus of $50,000, therefore $10,000 was available for dividends. Thus you see, with a computation of what you may or may not do under the terms of that contract, the earned surplus as of the beginning of the year must be taken into account. Therefore, I think that the question as to whether or not that computation in the regulation is or is not applicable depends upon the wording of the restriction in the contract which prohibits the payment of it. I think the regulations would have been wiser if they had spelled out a little more carefully the facts upon which its conclusions were based.

QUESTION: If a liquidating corporation pays a dividend to the parent company prior to liquidation, will not this dividend be treated as part of the liquidation, therefore not a "taxable dividend"? Thus, there will be no dividend credit to the subsidiary.

ANSWER: That question I assume is based upon the ruling of the Treasury Department which has been confirmed by the courts that, where a corporation pays a dividend immediately prior to liquidation and the payment of that dividend is really a step in the process of the liquidation, they will treat that dividend not as a regular dividend but as a liquidating dividend. Therefore, the question is raised that if a subsidiary is to be dissolved under Section 112-b (6) and, immediately prior to its dissolution in order to avoid the surtax it pays out all of its earnings for the fiscal year in excess of what has already been paid out, will not the Commissioner come back and claim that this rule applies and that, therefore, it is a payment in liquidation and you get no credit for it?

I think not. I think the argument can be advanced with reason, but I think, in the first place, that, for a corporation before liquidating to pay out the balance of its earnings for the current year, would be held to be rather in the nature of a regular dividend rather than in the nature of a liquidating payment. Furthermore, putting the whole statute together, I think the court would be very apt to say that it is contemplated that such action can be taken—that, inasmuch as a credit is being given to the corporation if it does do so—it is contemplated that the corporation may avail itself of the credit and that is the only way it can do so. But finally I do not think the Government is apt to raise that question. If

it treats that payment as a regular dividend and not a liquidating dividend it is going to be taxable to the corporation as a dividend and is going to be taxable to its recipients. If it treats it as a liquidating dividend it may not be taxable, therefore I think the tendency of the Department will be to treat it as a regular dividend which the corporation purported to pay out in order to be sure to get a tax on it as a dividend.

QUESTION: Corporation "A", a New York corporation, on December 31, 1935, had a deficit of $7,000. During 1936 a gain of $6,000 is expected.

Despite the deficit, the $6,000 is distributed to stockholders to minimize tax on undivided profits.

(a) What would the attitude of the Department be in view of the deficit?

ANSWER: Now that brings me to a point that I meant to mention before. Section 115 of the Act, defines "Dividends" and "Distributions" and discusses their uses but, unfortunately, the phrase "earnings or profits" is not defined. That expression does not fit into the words "net income" and you may have considerable difficulty in applying and fitting Section 115 into the other sections because the other sections use the words "net income" (which is a statutorily defined phrase).

If you will follow me I will give you an illustration which will bring out a serious difficulty which is involved. Let us assume a corporation, at the beginning of 1936, had no surplus at all. As at the beginning of the year, its assets (at a fair value) were just equal to its capital stock. Then, in the year 1936, it has a current operating profit of $100,000. During the year it sells capital assets with a loss of $200,000. Now, inasmuch as that loss is limited to $2,000, in determining net income, its statutory net income will be $98,000. Now what can the corporation do about it? The corporation can do nothing about it because of Section 113. A dividend of $98,000 will still not be out of earnings and profits earned before January 1st because the corporation did not have any, and the corporation did not have any earnings and profits for the year 1936.

That is an illustration of how you can get into an impasse between Section 115, defining dividends in terms of earnings and profits when a tax is imposed upon net income which is an entirely different concept. Frankly, I do not know how the corporation could possibly avoid the payment of that surtax, because any distribution it made to the stockholders is bound to be a distribution out of capital; thus it would not be taxable to them, and it would not be a credit to the corporation.

What would the attitude of the Department be in view of the deficit? I should say that in the particular case here given, no problem would be presented because the corporation, although it had a deficit at the beginning of the year and earnings and profits of $6,000 during 1936, could pay out $6,000, which under Section 113 would be a taxable dividend. The problem only arises when the corporation has no earnings and profits.

(b) What would the attitude of the State authorities be re declaration of dividend with no surplus available?

Under the laws of the State of New York it would be a violation of the Penal Code and the directors who declared the dividend and the officers who paid

the dividend would be guilty of a misdemeanor and would be subject to criminal prosecution. Under the laws of New York, the directors who order the distribution would be personally liable to refund to the corporation the amount of the dividend.

QUESTION: Can you not explain a way the apparent conflict between the Federal surtax on undistributed earnings of corporations operating on a deficit and those State statutes prohibiting payment of dividends by corporations carrying deficits on their books by the doctrine that Federal law prevails where State and Federal laws conflict?

ANSWER: Well, I do not think that is a correct premise. The Federal law prevails only over the State law in certain fields; also, I do not think there is any conflict. The Federal statute says there is a surtax on your profits unless you pay a dividend. The State law, under certain circumstances says that you are prohibited from paying a dividend. Logically, there is no conflict; all that happens is that, by virtue of an existing law, that corporation cannot take advantage of a credit that the Federal Government would give it.

QUESTION: Section 115 provides for taxation as a "dividend" of a distribution made in 1936 where there are ample earnings for the current year to cover the dividend, even though an actual operating deficit existed at the beginning of the year sufficiently large to offset the current year earnings. Would the stockholder receiving the distribution be justified in resisting taxation thereof as an ordinary dividend on the ground that no true income is received and that the tax is in fact one upon capital, not apportioned, and therefore unconstitutional?

If the stockholder's contention is upheld would that fact necessarily deprive the corporation of the corresponding dividend credit provided for in Section 27?

ANSWER: Well, that is a difficult question. That provision of the statute is a new one; it was put into the statute for administrative reasons to do away with an uncertainty that heretofore existed. As the statute heretofore existed, there were quite a number of corporations—for example, corporations existing under the laws of Delaware—that were permitted to pay dividends out of current profits even though they had a deficit in their capital account. Those corporations insisted, therefore, that they could go on year after year paying dividends to their stockholders and they would never be taxable because they had a deficit in their capital account. To avoid that, the Federal tax statute was changed so as to provide that, if you have a current income and do pay a dividend out of that income, it shall be taxed as a dividend.

I admit that the question is not free from doubt, but I think the weight of the argument would be in favor of the constitutionality of the provision.

QUESTION: If a corporation has common stock only, does the payment of a dividend in a new preferred stock give it a dividend credit?

ANSWER: I should say that the answer is, no, it does not, because payment in the new preferred stock under those circumstances would not change the

proportion of interests of the stockholders of a company. If a man owned 1% of the common stock, then after this preferred dividend was declared, he would own 1% of the common and 1% of the preferred stock or proportionately the same as he owned before; therefore the dividend would not be taxable in his hands and therefore the corporation would not get a credit.

QUESTION: Under the common law, stockholders may, by unanimous consent, agree to a distribution in proportions other than stockholdings.

If stockholder "A", owning 60% of the stock permits "B", owning 40% of the stock to take 50% of the dividend, is the corporation denied the credit for the dividend paid?

ANSWER: I should say that the statute says that it will be denied. I think that probably there is a policy of the law back of it. In order to collect the taxes which the Treasury Department regards due, it is necessary that the dividend be declared in accordance with proportionate interests of the stockholders. If that were not so, the larger stockholder could, because of his relationship or friendship or any other consideration, permit it to be paid to another with a lower tax rate on it than the man who really owned the stock. In order to avoid the possibility of passing income from the person in the higher brackets to the person in the lower brackets, the provision was inserted that the corporation does not get the credit unless the dividend is paid proportionately.

QUESTION: In 1927, a corporation had outstanding common stock only and declared a dividend on such common stock in preferred stock. Such preferred stock dividend was not recognized as a dividend for tax purposes at that time. In May, 1936, the preferred stockholders were invited to turn in their shares to the corporation and receive common stock in exchange. About 80% of the preferred stockholders accepted this offer and turned in their preferred stock which was then retired. On July 1, 1936, the company called the remaining outstanding shares of preferred stock for retirement at $110 per share, the $10 being premium.

The question is, whether, since when the preferred stock was originally issued as a dividend, it was not recognized as such for tax purposes, can all, or any part of the amount paid in retirement of the amount of preferred stock outstanding in July, 1936, be considered a dividend which can be used as a credit in determining surtax on undistributed profits or will such credit be denied on the grounds that, inasmuch as the payment was made to redeem only a portion of the preferred stock which was issued as a stock dividend, it represented a preferential distribution within the meaning of Article 27-7 of the 1936 regulations?

ANSWER: I should say that would not be a preferential dividend. At the time that dividend was declared, namely July 1, 1936, the corporation had outstanding only a certain amount of preferred stock, the balance of it had gone. When it called that preferred stock, in July, 1936, it called all there was outstanding; therefore, as I see it, there was no preference because the statute only requires a like treatment of stock of the same class which is outstanding at that time.

I may also say that there is another question involved which is not asked, and that is this: It is true that that preferred stock, having been declared as a dividend to the common stockholders, may not be a taxable dividend. However, having been declared as a stock dividend and then subsequently retired, there is a provision in the tax law to the effect that, where a dividend has been declared in stock and subsequently returned under such circumstances that it is substantially equivalent to a cash dividend, it will be treated as though it were a cash dividend on its retirement. If the Treasury Department should claim that the retirement of that preferred stock was substantially equivalent to a cash dividend, it may follow that the corporation would be entitled to a dividend credit.

Answered by Henry B. Fernald and Edward H. Green

Question: Where a corporation is required by express agreement made prior to May, 1936, to withhold 50% of earnings from payment of dividends, and the 50% so withheld in 1936 remains in surplus, the balance being paid out in dividends, is the Treasury justified in treating the 50% remaining in surplus as "available" for dividends in 1937 as *seems* to be indicated by example in the regulations?

Answer by Mr. Fernald: Personally I am very doubtful whether the Treasury Department is correct in the illustrations it gives in Article 26-3 (b), Examples 1 and 2, where it provides for drawing on prior surplus for payment of dividends regardless of these contract provisions. However, I shall ask Mr. Green for his opinion.

Answer by Mr. Green: It seems to me that the answer to this question depends entirely upon the wording of the express agreement entered into by the corporation. If this agreement requires that the amount withheld from 1935 earnings should continue to be withheld in 1936, then it would seem to follow that this amount cannot be taken into account in determining the fund available for the declaration of dividends in 1936. However, if the covenant is such that any of the earnings for 1935 are after that year released for the payment of dividends in subsequent years, then such earnings might well be taken into account in determining the fund available for the declaration of dividends in subsequent years, without violating any covenant of the corporation.

Answered by Leo Mattersdorf

Question: A corporation declares a dividend in December, 1935, payable in January, 1936. Is this a dividend credit on 1936 surtaxes?

Answer: Yes, provided the dividend is paid in 1936.

Question: On the question of credit to a corporation for dividends — If a corporation made payment to stockholders out of 1935 earnings on January 5, 1936,

it would follow, would it not, that the corporation may use the credit for 1936 tax purposes?

ANSWER: Yes.

QUESTION: A corporation pays $25,000 dividend on December 31, 1935, received by stockholders on January 2, 1936; on December 31, 1936, it pays $20,000 received by stockholders on January 2, 1937. Which is deductible?

ANSWER: That goes back to the question that Mr. Green discussed, as to the actual date of payment. If the Treasury regulations stand, then the date of receipt by the stockholders would cover — January 2, 1936 — and it would be entitled to the $25,000 credit; if they do not stand, making the dividend available to the stockholders, then it would be entitled to $20,000 credit.

QUESTION: Is a personal holding company subject to the undistributed profits tax?

ANSWER: Yes.

QUESTION: In the following cases, would you consider that dividends were paid during the taxable year?

The dividends were declared payable in the taxable year and (a) were credited to the individual accounts of the stockholders and were available to them upon demand; (b) demand notes were given to the stockholders during the taxable year. In both cases, the stockholders have included the dividends in their individual income tax returns in the taxable year.

ANSWER: I am going to read the section of the regulations on that. "If the corporation, instead of paying a dividend directly to the shareholder, credits the account of the shareholder on the books of the corporation the amount of the dividend, the credit for the dividend paid will not be allowed unless it is shown to the satisfaction of the Commissioner that such credit constitutes a payment of a dividend to the shareholder within the taxable year".

With reference to (b), there is the statement: "In both cases the stockholders have included it in their individual income tax returns during the taxable year".

I will read this from the regulations: "If the dividend is payable in obligations of the corporation, they should be entered or registered in the taxable year on the books of the corporation, in the name of the shareholder (or his nominee or transferee), and, in the case of obligations payable to bearer, should be received in the taxable year by the shareholder (or his nominee or transferee), to constitute payment of the dividend within the taxable year".

QUESTION: A corporation obtains a two-year loan of $500,000 in December, 1935, and agrees with the lender not to pay any dividends until the loan is paid off. It has an earned surplus on January 1, 1936 of $1,000,000 entirely invested in plant. It has earnings of $200,000 in 1936. It pays no dividends in 1936. What credit is it entitled to under Section 26 (c)-1?

Answer: If the agreement is written it would be entitled to a credit up to the full amount of the adjusted net income.

Answered by Dr. Joseph J. Klein

Question: (a) What is your opinion of the provisions of Article 27-6 of the regulations (1) that a distribution in a tax-free liquidation of a subsidiary will not give a dividend paid credit; (b) that in case of liquidation of a subsidiary the parent may allocate part of its dividends paid after the transfer of assets and apply it as a dividend credit for the subsidiary? Would it be advisable for the subsidiary company to first pay a dividend to the parent company before dissolving?

Answer: The express language of Section 27 (f) does not on the face of it seem to warrant the conclusion that a distribution in complete liquidation does not result in a dividend paid credit even though the distribution is in a tax-free liquidation of a subsidiary.

Section 115 (a) gives a definition of a dividend. There has been added this year the new provision as to a distribution out of current earnings "without regard to the amount of the earnings or profits at the time the distribution was made". Congress by express definition undertakes to define as a dividend, and hence as taxable income to the recipient, that which accountants would regard as capital.

There is the provision in Section 27 (h) that if any part of a distribution is not a taxable dividend in the hands of such stockholders as are subject to taxation, no dividends paid credit shall be allowed with respect thereto. If the corporation made a distribution which it considered as out of current earnings under Section 115 (a) (2), thus claiming the distribution as a dividends paid credit, but if the recipient stockholder should refuse to treat this as taxable income on the ground that the distribution was out of capital or tax-free because of the provisions of Section 112 (b) (6) and if the courts should eventually hold that such a distribution was not a taxable dividend, then it seems to me that the dividends paid credit would lapse.

Section 27 (f) in the presence of all these qualifying subsections, in language as clear as any language in the statute, provides for including in the dividends paid credit "distributions in liquidation",—without qualification as to whether or not these are taxable or tax-exempt,—but only if properly chargeable to the earnings or profits accumulated after February 28, 1913. There is the question of when a distribution is "properly chargeable" to such profits, but certainly the view of accountants would be that a distribution is chargeable to current earnings if in closing the books of the dissolved corporation the charge must be made against such earnings.

As to the question of whether, before a subsidiary is dissolved which has current earnings for the year, you should try first to make the distribution of such earnings, there may be question whether you should make the distribution and have the parent pay the tax equivalent to 2¼% of that amount or take the chance that the parent may be permitted by the Commissioner to make the allocation or that Section 27 (f) might be held applicable. I think I would be more inclined to incur the 2¼% tax on the dividend paid than take the chance of having the

parent permitted to make the allocation or having the distribution allowed as a dividend paid credit under Section 27 (f).

Answered by FRANKLIN C. ELLIS

QUESTION: The minutes of a corporation provide a minimum salary to its president of $20,000 per year; and additional salary of 5% on sales in excess of $500,000, but not to exceed an additional remuneration of $10,000 per annum. Is this a contract within the meaning of the law, and hence, a deduction, or credit, in the determination of adjusted net profit?

ANSWER: The only contracts forming the basis of credit for undistributed profits tax are those restricting payment of dividends. The contract outlined would therefore not qualify under this provision; however, the compensation of the officer in question (including the portion based on sales volume) would be an allowable deduction (unless excessive) and would reduce income subject to both the normal corporation tax and the surtax on undistributed income.

QUESTION: Dividend checks for $100,000 are made payable to stockholders, who endorse them and they are redeposited in the corporation for capital stock. Is this dividend a proper credit for the undistributed profits tax?

ANSWER: If such dividend is declared and paid without restriction and the purchase of stock is an independent and separate transaction, the dividend would be deductible. If, however, the transaction has not been consummated it would be better practice and all questions would be eliminated by stockholders giving their own checks for the new stock.

QUESTION: A subsidiary company on a calendar year basis pays a dividend to its parent company which is on a fiscal year basis. The parent company pays no tax on this dividend being under the 1934 Act. Will this dividend be allowed as a deduction to the subsidiary company for the computation of its surtax?

ANSWER: Yes, the dividend paid credit is not limited to the amount upon which individual stockholders pay tax but only by the qualification that the distribution would be taxable as income under the 1936 Act.

QUESTION: A corporation desires to pay out $50,000 in dividends by a bond issue where the immediate market value of the bonds is $40,000. It therefore pays out $5/4 \times$ $50,000 in bonds and charges $50,000 as a dividend. May the difference between $50,000 and $5/4 \times$ $50,000 be amortized over the life of the bond and charged off as a loss?

ANSWER: The excess of par value of bonds over the market value is deductible as a distribution under the law (Article 27-4) only when the bonds are paid. No amortization is allowable, in fact no loss is sustained since the bonds are recorded at face value at their issuance.

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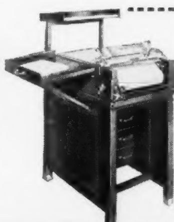

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REFUNDS *of* PROCESSING *and* FLOOR STOCKS TAXES *and the* UNJUST ENRICHMENT (WINDFALL) TAX

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Refunds of Processing and Floor Stocks Taxes and the Unjust Enrichment (Windfall) Tax

By JOSEPH GETZ, C.P.A.

ON January 6, 1936, the Supreme Court of the United States rendered its decision in the case of William M. Butler, et al., Receivers of the Hoosac Mills Corporation, invalidating the Agricultural Adjustment Act as unconstitutional. Thus, there came to an end, one of the major pieces of legislation of the present national administration, and a contest regarding the constitutionality of the law, which had commenced with it enactment.

With the law thus disposed of, another contest ensued — on the one hand, by the taxpayers who had been subjected to the tax, as to how they could get refunds; and on the other hand, by the Government, in its efforts to minimize refunds, or the retaining what the President called, a windfall of a tax which had already been passed on to others in higher prices. Many persons who had been subject to the Agricultural Adjustment Act, and who had entertained doubts as to its validity, had resisted payment of the tax, either by filing claims for refund after payment, followed by suits in the courts, or by refusing to pay and enjoining the collector from enforcing collection, whereupon on the court's order, the funds were impounded, to await the decision of the United States Supreme Court. Also, especially during the latter part of 1935, a situation prevailed in many places, wherein taxpayers had made no payments at all, anticipating that the decision would not require eventual payment.

That the subject of refunds is of vast proportions and importance to business in general and to specific taxpayers, is indicated by the statement of the Senate Finance Committee in its report on the 1936 Revenue Act, wherein the following was said:

> "The invalidation of the Agricultural Adjustment Act by the decision in the Butler case has given rise to possible claims for approximately $960,000,000 which has been collected under that act. This amount consists of approximately $850,000,000 in processing taxes; $98,000,000 in floor stocks taxes; and $12,000,000 in compensating taxes. Processing taxes were paid by approximately 73,000 taxpayers; compensating taxes, by 75,000 taxpayers; and approximately 1,000,000 taxpayers paid floor stocks taxes. The possible number of claims, therefore, exceeds 1,000,000. . . ."

The statement by the Senate Finance Committee would indicate that to us, as accountants, the subject warrants our attention and study.

It is difficult to ascertain or determine whether the Senate Committee's estimate of the extent of claims to be filed, is correct. The situation is somewhat unusual; the persons entitled to refund are not limited to those who actually paid the tax, but include those who suffered the burden of the

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tax which had been shifted to them by others. This different phase also presents itself in that portion of the Revenue Act of 1936 which we are about to consider — the Windfall Tax — whereby persons who did not receive refunds directly from the Government are also aimed at because certain moneys they had received from their vendors are considered recoupments of the tax.

Before going into the subject of refunds which are allowable under the Revenue Act of 1936, and the provisions under that Act for a tax on Unjust Enrichment, called the Windfall Tax, I believe it would probably not be amiss to briefly sketch the background before the Butler decision.

The Agricultural Adjustment Act

On May 12, 1933, the President of the United States approved the Agricultural Adjustment Act, which stated, according to its declaration of policy, that a severe and increasing disparity existed between the prices of agricultural and other commodities, which disparity had largely destroyed the purchasing power of farmers to buy industrial products. Generally, it was intended, according to the plan of the Act, that the cure for this situation was to impose on the first domestic processing of certain basic agricultural commodities, a tax, representing an amount which was to be determined by the Secretary of Agriculture, and which would represent the difference between the then prevailing prices and the prices of such agricultural commodities during the pre-war period from August, 1909 to July, 1914, or what was called the parity prices. The proceeds of the tax thus obtained, were to be expended in payments of benefits to farmers in various parts of the country for the curtailment by them of the production of these basic commodities. For our purpose, it is unnecessary to go into the benefit phase of the Act, inasmuch as our interest is centered about matters relating to the tax.

The AAA provided that the processing tax would go into effect with respect to the commodity or article, by virtue of a proclamation by the Secretary of Agriculture, wherein he was to determine what benefits were to be paid in respect to the basic agricultural commodity, and in such event, a processing tax would be in effect from the beginning of the marketing year next following the date of such proclamation. The commodities which the AAA, as amended, considered as basic, to warrant such a tax on the first domestic processing, were as follows: wheat, cotton, field corn, hogs, rice, tobacco, milk and its products, rye, flax, grain sorghums, cattle, potatoes, sugar beets, sugar cane and peanuts. Under the Act, also, the processing tax was to apply to any commodity which the Secretary of Agriculture would proclaim to be competing disadvantageously with any of the above-named basic agricultural commodities. Up to January 6, 1936, processing taxes had become effective by proclamation of the Secretary of Agriculture on all the above-mentioned commodities, except barley, cattle, flax, grain sorghums and milk, and in addition, on some paper and jute products which were competing with cotton.

According to the theory of the law, it was necessary to allocate the burden of the benefits paid to farmers to all ultimate consumers of articles processed from such commodities after the effective date. This could only be fully accomplished if inventories, imports and competing products were equally loaded with their share of the tax. Therefore, the law provided that upon such date as a processing tax became effective:

(a) Those having inventories on hand of any article processed wholly or in chief value from any commodity with respect to which a processing tax was to be levied, would be subject to tax. This was titled the "Floor Stocks Tax".(1) Retailers, however, were not subject to such tax until 30 days thereafter.(2)

(b) Importations from any foreign country or any possession of the United States to which the Act did not apply, of a commodity or an article of which the chief value was a commodity which was subject to the processing tax, were also weighted with a tax to bring the price up to that of the domestic article. This was called the "Compensating Tax".

(c) In addition to the Floor Stocks and Compensating Taxes, the Secretary of Agriculture was authorized, if he found commodities competing disadvantageously with any of the taxable commodities, to impose a tax upon such competing articles. Thus, for example, a tax was imposed on certain paper, jute fabrics, jute yarn and reinforced paper fabrics.

The respective taxes on processing, floor stocks and on competing articles were payable to the Collector of Internal Revenue. The compensating taxes were collected by Collectors of Customs, practically in the same manner as duties upon imports, but these funds, however, subsequently found their way into the Bureau of Internal Revenue, and accordingly, such funds are subject to the same general rules as to refunds as are the other taxes.

In conjunction with the Agricultural Adjustment Act, there should also be mentioned two other Acts requiring tax payments, with regard to which refunds may be claimed. First, the Bankhead Cotton Control Act, which was approved April 21, 1934, and was subsequently amended. This Act provided for a tax on the ginning of cotton of 50 per cent of the average central market price per pound of lint cotton, but in any event, not less than five cents per pound. Second, the Kerr Tobacco Control Act, which was approved June 28, 1934, and which levied a tax at the rate of 33⅓ per cent of the price for which tobacco was sold. Such tax was levied on the seller, who would be the producer of the tobacco.

Under the AAA, the processing taxes were levied on the first domestic processing, which means generally, in the case of wheat, rice and corn, the milling; in the case of cotton, the spinning and manufacturing; and in the case of hogs, the slaughter of hogs for market. Generally, the definition

Footnotes: (1) The Floor Stocks Tax also applied to inventories on hand, in the event that the rate of tax on the processing of a commodity was subsequently increased.

(2) As a practical matter, the floor stocks tax on retailers was based on the inventory 30 days after the enactment of the Act, less goods received during the 30-day period.

of processing means "any manufacturing or other fabrication involving a change in the form of a commodity, or its preparation for market". An article processed wholly or in chief value from the commodity, has been defined to mean "those made of two or more components, the taxable commodity constituting a component having a value greater than any other component". (3) The liability for the tax was on the first domestic processing of the commodity and not upon the sale of the article. The regulations provided that the taxes were to be paid when the returns were due, which was before the end of the month following the month of processing. The law, as amended in 1935, however, authorized the Secretary of the Treasury to permit a postponement of the payment of not more than three-fourths of the amount of the tax for a period of 180 days from the due date.

Treasury Decisions and Regulations under the AAA

Following the passage of the AAA, the Secretary of Agriculture, at various times and with regard to various commodities, proclaimed the effective dates of imposition of the tax, and the respective rates at which such taxes were to be imposed. Following these proclamations, the Secretary of the Treasury issued regulations and Treasury decisions, wherein were shown the conversion factors and rates of tax for articles processed from the particular commodity on the date when the particular tax became effective. The effective dates, the conversion factors and rates, are an important reference in regard to all matters of refunds and tax liability under the Windfall Tax. The material contained in these regulations and Treasury decisions is of a technical nature, which would probably cause the subject to become too involved for present discussion, but nevertheless, of importance in handling all processing tax matters. An enumeration of the effective dates and the decisions which contain the rates of tax on each commodity, and the conversion factors showing the percentage of content of the taxable commodity in the processed article, are submitted:

Commodity	*Treasury Decision*	*Date of Initial Imposition of Tax*
Wheat	4579	July 9, 1933
Cotton	4433	August 1, 1933
Tobacco	4610	October 1, 1933
Field Corn	4407	November 5, 1933
Hogs	4518	November 5, 1933
Paper and Jute	4495 and 4415	December 1, 1933
Sugar	4549	June 8, 1934 except that in the Philippine Islands the effective date was September 12, 1934.
Peanuts	4489	October 1, 1934
Rice	4586	April 1, 1935
Rye	4601	September 1, 1935
Re-inforced Paper Fabric	4611	November 1, 1935

Footnote: (3) Article 2, Regulations 81.

Section 21-D of the AAA

Further development of the background of the subject of refunds requires mention of the amendments to the AAA passed in 1935. Towards the middle of 1935, decisions in the Federal District Courts and in the United States Circuit Courts of Appeal gave rise to serious doubts as to the constitutionality of the AAA and its sister Acts. The 74th Congress attempted to remedy the unconstitutionality features; and in addition, tried in a way to forestall a deluge of claims for refunds, should the decision of the Supreme Court be adverse. It is in Section 21-D then enacted that we find the antecedents of Title VII of the Revenue Act of 1936, particularly as to the subject of shifting the burden.

Court Decisions on the AAA

Some of the decisions in cases in the courts, following the Butler decision, present several aspects of the refund matter. The Butler decision had dealt with the right of the Government to collect the tax under the AAA. That suit had arisen through the rejection of the claim of the Government for the processing tax by the receiver appointed for the Hoosac Mills. In cases where taxes were impounded with the court, the right to return of the funds was decided on January 13, 1936, by the Supreme Court, in *Rickert Rice Mills* vs. *Fontenot.* This case was based on an injunction which had been granted, and the decision provided that re-payment of the tax should be made to the processors. The Rickert decision had the following effect: Processors who had not paid the tax, but who had either posted a bond therefor or had such tax impounded, were entitled to a release of the bond or a return of the impounded taxes; and those who had not paid the tax because of an extension of time or other reason, were no longer required to pay the tax. The Butler and Rickert decisions established the fact that wholesalers, jobbers and others were entitled to refunds on their inventories as of January 6, 1936, the date the Act was determined to be invalid. There was still to be determined the disposition of cases of processors who had paid the tax, but who evidently were not entitled to refunds, unless they could prove that the burden of the tax was not shifted by them, as required under Section 21-D of the AAA.

An anomalous situation existed in cases where suits for recovery of processing taxes were instituted. In the case of *Wilkes Barre Lace Manufacturing Co.* vs. *Mundy,* the court held that in an action for the refund of processing taxes which was instituted prior to the date of enactment of Section 21-D, August 24, 1935, there was no need to prove that the taxes had not been shifted, and the Section should not be given retroactive effect. However, in a case in the Eastern District of New York—*Atlantic Macaroni Co.* vs. *Corwin,* the court held that a taxpayer who failed to comply with Section 21-D was not entitled to a refund of processing taxes, even though suit was commenced before the date of the enactment of Section 21-D. It may be noted, however, that on the other side of the Brooklyn Bridge, the law was interpreted differently. In *Edwin Cigar Co.* vs. *Higgins,* the court held that Section 21-D was unconstitutional because of its inequitable provision that, if a taxpayer had

passed on the burden of all or only a part of the illegally collected tax, that he could not subsequently recover any part thereof. In one case so far reported, where Section 902 of the Revenue Act of 1936[4] was considered, the Alabama District Court decided in *Lincoln Mills of Alabama* vs. *Davis*, that the processor was not entitled to a refund, unless he established the fact that he alone had borne the burden of the tax, and that he in no way shifted it to others.

What will happen, should the Supreme Court of the United States eventually hold that Section 902 of the 1936 Act is not to be given retroactive effect? Will taxpayers, who instituted suit prior to June 22, 1936,[5] be entitled to refund without having to establish that they bore the burden? Will they be required to submit proof of not having shifted the burden in case Section 21-D is declared unconstitutional, if they instituted suit after August 24, 1935, but before June 22, 1936? One cannot help but wonder whether contentious taxpayers will be in a better position than the acquiescent ones.

Refunds under Title IV of the Revenue Act of 1936

Refunds of taxes which were paid under the Agricultural Adjustment Act are considered under two Titles of the Revenue Act of 1936.

Under Title IV, provision is made for refunds:

1. Where the commodity was exported or was delivered for charitable distribution or use;
2. Where adjustment had been made in the rates; and
3. Where inventories of tax-burdened merchandise was on hand on January 6, 1936.

Title VII provides for refunds of taxes which have been paid as processing taxes, as compensating taxes, or as floor stocks taxes, where it is definitely established that the taxpayer bore the burden of same and has not been relieved, nor reimbursed therefor, and has not shifted such burden directly or indirectly to others.

The purpose of the provisions with regard to the allowance of refund under Title IV was to reenact certain provisions of the Agricultural Adjustment Act, allowing such refunds because there existed some doubt as to the legal authority of the Commissioner of Internal Revenue to continue making such refunds, in view of the invalidity of the AAA. With the exception of claims for refund where there had been an adjustment in the rate, as in the case of cotton used in the manufacture of large cotton bags, no claims for refund under Title IV can be made by the processor or other persons who paid the tax. It is presumed that Title VII makes adequate provision for such taxpayers. Claims for refund under Title IV must be filed prior to January 1, 1937, and will not be allowed in amounts of less than $10. Inter-

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Footnotes: (4) This section restricts the allowance of refunds to taxpayers who can prove that they alone bore the economic burden of the tax, and did not shift the amount thereof to others.

(5) The Revenue Act of 1936 was approved June 22, 1936.

est will not be payable on allowances which may be made. The claims allowable under Section 601 are limited to those cases where the delivery for charitable distribution or use and the exportation took place prior to January 6, 1936, and no refund is allowable when the amount was claimed as a credit against any tax due under the AAA. It is necessary with all claims under Title IV, that the taxpayer submit proof that he is not entitled to receive reimbursement of the amount of tax, or any part thereof, from the processor or vendor of the taxable article, but it is not necessary for him to prove that the tax with respect to the article on which the claim is based, was paid by the person subject to the tax.

Claims for Refund—Delivery for Charitable Distribution or Use

Where a claim is submitted on the ground that the commodity or article was delivered for charitable distribution or use, it is necessary to submit:

1. A description of the product delivered as shall be required to determine the rate of refund or credit applicable, in accordance with the conversion factors established in the particular Treasury decision;
2. The quantity of each product delivered and the net tax content thereof;
3. The name and address of the organization and the date of delivery to such organization;
4. The distribution and use to be made of the product by the organization;
5. A copy of the Bill of Lading; and
6. Proofs satisfactory to the Commissioner that the tax was not included in the price of the product delivered to the organization, or that the claimant had agreed to repay such amount to them.

Claims for Refund—Exported Articles

Claims with respect to exported articles may be made by the consignor; and in some instances, by the shipper, provided the consignor has waived any claim of such refund to the shipper. Before any export refund claim can be allowed, it is essential that the claimant furnish evidence as to the kind of tax; the amount of tax; together with a Bill of Lading and other evidence that the article was actually exported. The requirement under the AAA and Regulations 83 that the claimant submit proof that the tax has been paid by the processor or vendor, is no longer necessary under the 1936 Act.

Floor Stock Tax Refunds

Perhaps the largest field of claims under Title IV will be those on floor stocks held on January 6, 1936, by wholesalers, jobbers and retailers. The effect of Section 602 of the 1936 Act is to put the holders of floor stocks in the same position as though the termination of the Act had occurred by proclamation, and differs in that respect only to the extent that it is based on the principle that refunds will be subject to an equitable limitation, namely: that the burden of the tax was not passed on to others after that

date. Any person who at the first moment of January 6, 1936 held for sale or other distribution, including manufacture or further processing, any article which was processed wholly or in chief value from a commodity subject to a processing tax, is entitled to a refund of an amount equal to the tax which would have been payable in respect to the commodity, if the processing had occurred on January 5, 1936. A limitation on the portion of the claim allowable is the amount of the burden of the tax which was shifted to him in the price he paid for such article, or, if he was entitled to reimbursement from his vendor, only to the extent that he has not received such reimbursement. Another limitation on the refund is that the burden of the tax applicable to the article was not passed on by the claimant to his vendees, or that it has been included in the sales price of such articles.

Claims for refunds of the Floor Stocks Tax may be filed on one of the following forms: P. T. Form 71, representing claims with respect to articles held elsewhere than in retail stocks; and P. T. Form 72, representing claims with respect to articles in separate retail stocks. Claims on retail stocks are limited to three commodities—flour, cotton and sugar.

In support of a claim, it is necessary that the claimant allege in an affidavit:

1. That he was not the processor or other person who paid or was liable for the tax;
2. That the amount claimed is not in excess of the burden of the tax which was shifted to him in the price he paid for such articles;
3. That the amount claimed does not include any items for which the claimant has received or is entitled to receive reimbursement from his vendor;
4. That the amount claimed is not in excess of that part of the burden of tax applicable to articles held on January 6, 1936, which the claimant has not passed on to his vendees in the sales price of such articles after January 6, 1936.

The tax forms require that the information be submitted in detail, so that there is a complete description of each article forming a basis of the claim following the applicable Treasury decision as to conversion factors, and indicating the amount of payment claimed with respect to each article, listing separately, the specific amount as to each commodity from which the article was processed in order to support the total amount for which claim was made. The forms provide that with regard to the matter of tax burden, the affidavit of the claimant is sufficient. However, all evidence with regard to the claim should be carefully preserved, inasmuch as the Commissioner may require that such evidence be subsequently submitted should it be deemed necessary to establish the extent to which the claimant has borne the burden of the tax. The Commissioner may require, in addition to other information, that there be submitted:

1. The names and addresses of processors or vendors from whom the claimant purchased or acquired the taxable article;
2. The purchase price;
3. The amount of tax burden included in the purchase price;

4. The reimbursement which the claimant was entitled to receive from the vendors;
5. Sales prices in effect on January 5, 1936; and
6. The actual sales price, together with a showing as to the amount of burden passed on by the claimant to his vendees in the actual sales prices.

Procedure—Floor Stocks Tax Claims

As a practical proposition, the procedure with regard to the preparation of a claim for a refund of tax on floor stocks on hand as of January 6, 1936, may be along the following lines: It is necessary to establish a separate inventory of the items for which claim may be made, listing such items at each shop, branch or establishment at which the claimant conducts his business, and such items as are held in each warehouse or place of storage, or in transit, and also distinguishing what is held in separate retail stocks. It can hardly be expected that the claimant would have such a complete inventory as of the morning of January 6, 1936, unless detailed and accurate stock records were maintained, which can produce such information. In the absence of stock records, the inventory of taxable items must be constructed from the physical inventory which was taken on the date closest to January 6, 1936. The degree to which this inventory can be accurately established will often determine the acceptability of the claim by the Commissioner. The inventory of taxable items should be prepared in duplicate, and if the stocks are held at various locations, the respective inventories should be consolidated. The inventory records are required to be kept by the taxpayer for a period of four years from the date of the filing of the claim. If the inventory represents a constructed inventory, it is apparent that it would be necessary to preserve the last physical inventory, together with the working papers showing the details of additions and subtractions to arrive at the said inventory as of January 6, 1936. The taxable articles in the inventory must be converted and stated in the prescribed units, in accordance with the definition and classification prescribed therefor in the applicable Treasury decision. The information with regard to reimbursements from vendors and payments to the claimant's customers will undoubtedly be easily ascertainable from the claimant's records. Proof that the tax with respect to the articles were shifted to the claimant in the price he paid, and proof that the claimant did not shift the burden and has not passed the tax on to his vendees in the sales prices of such articles, represents a special problem in each case. Such evidence may be data showing that prices of the articles purchased after the imposition of the tax were higher than before, or that the burden of the tax included in the purchase price was offset in other ways. Proof that the burden was not shifted to the claimant's customers can perhaps be presented in a number of ways; for instance, by evidence that the sales price of the article was reduced after January 6, 1936, or that the items in the inventory were subsequently sold at a lesser price, or that the taxpayer had made no changes with regard to the grade, the quality or the quantity of the product, and had maintained a fixed price before and after January 6, 1936. The proof

would be obvious in a case where the claimant had sold the article at a fixed price before, during and after the period of imposition of the tax, and that during that period, he had been required to pay a higher price for the commodity going into his product, because of the inclusion of the tax in the purchase price.

Claims for Refund—Under Title VII of the Revenue Act of 1936

Title VII of the Revenue Act of 1936 relates to claims for refund which may be submitted by the processor or any other person *who paid the tax*. In this category may be placed the processors who paid the tax on the first domestic processing, persons who paid the floor stocks tax when the tax with respect to the particular commodity first became effective, and persons who paid a compensating tax upon importations into the United States from any foreign country. The basic theory underlying the allowance of any claims for refund under this Title is that no claim will be allowable unless the claimant can establish to the satisfaction of the Commissioner of Internal Revenue, that he alone has borne the economic burden of the tax for which he seeks refund.

The law provides that claims for refund of processing taxes must be filed with the Commissioner of Internal Revenue, who must either allow or disallow the claim within a period of three years, unless such limitation period is mutually extended by agreement. Upon disallowance of any claim, the taxpayer has the right to appeal within 90 days to a newly created Board of Review, which will function in a procedural manner similar to that of the United States Board of Tax Appeals. The decision of the Board of Review can be reversed by the United States Circuit Court of Appeals, and on the granting of a Writ of Certiorari, by the Supreme Court. No suit or proceeding on taxes, other than processing (compensating and floor stocks taxes) can be brought in the District Court, unless the Commissioner fails to render a decision within eighteen months from the date of the filing of a claim, or after two years from the date of rejection in whole or in part of a claim by the Commissioner.

Claims must be filed prior to July 1, 1937, with the Collector of Internal Revenue, on the forms prescribed therefor. Claims for less than $10 will not be allowed, nor will refunds be granted for any amount which the claimant or any other person has claimed as a credit against taxes due. Claims which were barred at the date of enactment of the Act cannot now be revived.(6) Interest will be allowed on the amount allowed as a refund at the rate of 6 per cent per annum, from the date the tax was paid. However, where the calculation of interest cannot be determined because of the difficulty of allocating a refund to a particular date of payment of the tax, the Commissioner has the right to use an average date.

Footnote: (6) The period of limitation under the AAA, in case of invalidity of the laws, was six months from that date, but since Title VII was passed within the six months period, the date has been extended to July 1, 1937. The period of limitation for which claims may be filed under Title IV, was one year, but the 1936 Act made the date January 1, 1937. Claims on any other grounds were originally limited to four years, but this limitation would be no longer applicable.

Claims must be supported by detailed proof. The claimant is privileged, however, to prove the facts in the manner best available to him, except that where the claim for refund is for a tax which is defined as a "processing tax", the proof as to shifting the burden must conform with a prescribed formula. All refunds under Title VII are allowable only to the person who paid the tax and are limited to such amounts as the claimant has borne, either through having paid the tax and not having received reimbursement from his vendors, or, having paid the tax, he repaid the amount thereof unconditionally to his vendees.

Under Section 902-B it is provided that, where the claim is based on the ground that the claimant has made repayment of such tax to his vendees, it must be established:

1. That such vendee bore the burden of the tax; and
2. That such vendee has not received any other reimbursement of such burden, directly or indirectly, or been relieved of said burden in any manner whatsoever.

This provision appears to be somewhat unreasonable, because it presumes to expect the claimant to prove facts which would not ordinarily be within his knowledge. Regulations 96 does not seem to shed any more light on the subject, but the Senate Finance Committee states that this provision is similar to Section 621-D of the Revenue Act of 1932. That particular section provides that no refund will be allowed if the tax has been passed on unless the ultimate consumer consents to the allowance of the refund to the claimant. It seems that the making of a re-payment by a claimant to his customer, over whom ostensibly he has no control, ought to be sufficient evidence that the payment was bona fide, and that logically, after such payment, the tax could not be considered as having been shifted to the claimant's vendees. It would be reasonable to assume that in cases where refunds were made to vendees, that an affidavit stating that such vendees had borne the burden of the tax, ought to satisfy the requirement of Section 902-B. Even this may be unnecessary where contracts with customers provided that reimbursement would be made to them only for those taxable articles which they had on hand on January 6, 1936, and conditional upon their excluding these items from their own claims for refund on floor stocks.

Claims for a refund of taxes on floor stocks which have been paid must be made on Form P.T. 76, and only one claim for all payments of floor stocks taxes may be filed. Each individual claim should show how and when the tax was paid to the Collector. The refund to any person will be limited to that amount for which the burden was borne and for which no refund or credit has been allowed to any other person.

Claims for refund of compensating taxes must be filed on Form P.T. 77 with the respective Collector of Internal Revenue where the customs port of entry is located. Separate claims must be filed for articles which were received through different ports of entry. Each claim should prove the payment of the tax and the refund will be limited to the amount for which

the claimant bore the burden, and for which no credit or refund has been allowed to any other person.

Under Title VII, a distinction is made between processing taxes and custom processing taxes. Custom processing is defined as the first domestic processing for a charge or a fee as differentiated from a sale of a commodity. Where the claim is based on custom processing, Form P.T. 78 should be used and a separate claim must be filed for each commodity, limited to one claim for that commodity, irrespective of dates of payment. The claim should show the dates of payment, and here again the refund will be limited only to the extent that the claimant has borne the burden of the tax.

Claims for Refund of Processing Taxes Paid

The difficult class of refund claims are those for Processing Taxes. These claims should be filed on Form P.T. 79. A separate claim should be filed for each commodity in this class, but the taxpayer is limited to one claim for all payments of taxes on such commodity.

The claimant should prove firstly, the payments of the taxes, and secondly, the extent that he bore the burden, and finally, that no refund or credit has been allowed by any other person. In regard to claims for refund of processing tax, the method of proof of shifting of burden is specified by the law and regulations, while such proof on claims for floor stocks taxes, compensating taxes, etc., is deemed sufficient if it is "clear and convincing".(7)

Section 907 of the law states that it shall be prima facie evidence that the burden of the tax was borne by the claimant to the extent (not exceeding the amount of the tax) that the average margin per unit of the commodity processed was lower during the tax period than the average margin was during the period before and after the tax. The tax period is defined "as the period within which such tax was effective", that is, from the date of the proclamation by the Secretary of Agriculture to the date of termination, January 6, 1936. The period "before the tax" is defined as "twenty-four months immediately preceding the effective date of the processing tax". The period "after the tax" is defined "as the six months, February to July, 1936, inclusive". If the average margin during the tax period is not lower than the period before and after, this, according to the law, is prima facie evidence that none of the burden of such tax was borne by the claimant, but that he had shifted it to others. The computation of the "margin" and the "average margin" must be prepared by the claimant on a monthly basis, showing for each month, sales, costs, number of units, and during the tax period, the amount of taxes paid. The average per unit is arrived at by combining the monthly totals of the period and dividing such totals by the number of units processed during the entire period.

First, there must be computed the total sales, which represents the total quantity by units of the article processed and subject to the tax, multiplied by the claimant's sales prices during the period. From this should be de-

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Footnote: (7) Article 202, Regulations 96.

ducted the actual cost of the commodities sold. The cost of the commodity should be the actual cost according to the accounting procedure of the claimant, but if such accounting procedure is inadequate, then the claimant is permitted to determine the cost of the commodity by taking the current prices at the time of processing for commodities of like quality and grade in the markets where the claimant customarily made his purchases. To the cost of the commodity there is added the processing taxes which were paid. This total, deducted from the total sales, leaves a balance which, when divided by the number of units, represents what the law calls the "margin" during the taxable period.

The method used for determining the average margin for the period before and after the tax is the same as that for determining the margin during the tax period, except that processing taxes are not added to the cost of the commodity.

The presumption as to "margin" or "average margin" is prima facie evidence as to the burden of the tax, and either the claimant or the Commissioner is privileged to submit other evidence in support of the presumption if it is in his favor, or, where it will rebut the presumption if it is against him. Claimants are required to preserve the records supporting their respective claims for a period of four years, after the filing of such claims. There is a provision in the regulations with regard to closing agreements in conjunction with a taxpayer's liability under the Unjust Enrichment Tax, but this point will be discussed in due course under its proper heading.

Claims for Reimbursement of Tax from Vendors

There is still another phase relating to the subject of refunds of processing taxes, to which the Government is not a direct party, but that which deals with claims of purchasers from their vendors. These claims relate to purchases of such commodities or articles, the chief component value of which was a taxable commodity, and in those instances where the tax was included or presumed to be included in the price of the merchandise. Frequently, contracts for the purchase and sale of commodities (especially prevalent during the latter half of 1935) contained clauses relative to subsequent adjustment of price to be granted by a vendor to his customer in the event that the Agricultural Adjustment Act was determined to be invalid. Such clauses were varied in form and embraced numerous requirements and stipulations. Some required that the reimbursement be made to the customer only if the taxes which had been impounded by court order or which had not been paid by the processor awaiting the Supreme Court decision, were returned to the vendor or remained unpaid. Other clauses provided that the reimbursement would only be made when, as, and if the vendor would obtain a refund of taxes from the Federal Government. In most cases, the amount payable to the customer was to be reduced by a pro rata share of the fees and expenses incurred by the taxpayer in procuring the refund, or in resisting payment of the tax. Still another type of agreement provided that the reimbursement to the customer would be made only on such floor stocks as the customer had on hand at the

termination date—January 6, 1936—and still others, that reimbursement would be made only for such stocks as had been delivered after the date of the agreement, and for which the customer was not entitled to file a claim for refund on his floor stocks. There was, of course, no homogenity as to the form and contents of these clauses, and the claims which may be made under these agreements, nor do we always find the agreement for reimbursement represented by a specific contract. In numerous instances, sales orders, purchase orders, special contracts and correspondence will be found to contain such reimbursement clause. Then, too, there may be cases involving oral agreements between the parties relative to reimbursement, which oral agreements may be valid and binding contracts.[8]

Concerns which have handled any taxable commodity during the tax period should determine whether their vendors have fulfilled their obligations under agreements to them for reimbursement. Difficulties may arise in situations where the vendors have agreed to make reimbursement to their customers only in the event that they would first receive a refund of the tax from the Government. A vendor, in order to obtain a refund, must file a claim under Title VII and prove that it is allowable. Because he is required to make reimbursement to his customers, he, (the taxpayer), may not be inclined to diligently pursue such a claim for refund. This disinclination is materially added to by reason of the fact that the vendor would be required to immediately turn the proceeds, less expenses, over to his customers, and the time and effort involved would be no more beneficial to him than a headache.

Another problem which will arise in regard to claims for reimbursement is to determine on what particular merchandise, or commodities processed during a certain period, the withheld tax or the refund applies, and to which customers it should go. Identification of the particular articles shipped may not be possible at the time, so that proof as to the identification of the merchandise by both sides may be necessary, with a possible controversial situation existing. A general rule adopted by many vendors, similar to the Government rule, is to identify the merchandise by the first-in-first-out rule.

In the initiation of claims against vendors, an important factor for the claimants to consider is whether the tax was passed on to their customers. They may gain very little from the successful outcome of a reimbursement claim from their vendors, because of the effect of the Windfall Tax on that portion of the reimbursement which the Government will consider subject to that tax.

Tax on Unjust Enrichment—Windfall Tax

The remainder of the subject assigned, is the tax on Unjust Enrichment, or Windfall Tax, provided for in Title III of the Revenue Act of 1936. This tax measure has been framed, as a purported income tax—a viewpoint involv-

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Footnote: (8) Vendors will not receive credit under Title III for any reimbursements made to their vendees pursuant to oral agreements if made after June 1, 1936.

ing serious constitutional considerations. It is on the net income of every person, arising from the sources mentioned in the Act, which are:

1. The net income from the sales of articles which were subject to a Federal Excise Tax, which tax was not paid to the extent that such net income is attributable to the shifting to others, the burden of such tax;
2. The net income from a refund or credit of an excise tax, the burden of which tax, the recipient did not absorb;
3. The net income from reimbursements, recoupments and refunds, which a person may have received from his vendors as an adjustment of price for a tax included therein, to the extent that such person has shifted to others the burden of such tax.

While the context of the law and regulations refers generally to Federal Excise Tax matters, it is no secret, that what it is after are the benefits or advantages some may have gained by the invalidation of the Agricultural Adjustment Act and its sister acts. Refunds of manufacturers' excise taxes imposed by the Revenue Act of 1932, on such articles as tires, toilet preparations, furs, jewelry, automobiles, etc., are not subject to the tax under Title III, because Section 621-D of the Revenue Act of 1932 has always provided suitable restrictions on the allowances of refunds or credits of such taxes, by requiring that a claimant prove that he had not included the tax in the price of the article, or that he had not collected the amount of the tax from his vendee, or, if he had, that he had repaid the tax to the ultimate purchaser, or had secured the consent of such ultimate purchaser to the allowance of the credit of refund to the claimant. Those responsible for the framing of Section III must have known that claimants for refunds had quite an assignment under Section 621-D, without shackling them with another.

The Windfall Tax, except in one respect, is not in any way tied up with Titles IV or VII. A claimant who receives a refund from the Government does not subject himself to a Windfall Tax of 80 per cent. The reason is manifest. He would not be entitled to the refund unless he could show that he had not shifted the tax and had himself borne the burden thereof, whereas the Windfall Tax is based only on a tax which is not shifted. There is a liaison in Section 506 of Title III, which allows for the joint consideration of a refund claim filed under Title VII and the Windfall Tax matters, for the purpose of a closing agreement. The thought that this may be advantageous to a taxpayer in avoiding a duplication of some of the work in meeting the requirements of the two Titles is not borne out by Article 26 of Regulations 95, which seems to have gone further than the context of the law in its interpretation. The regulations provide for a closing agreement under Section 506, if:

1. The taxpayer is liable for the Windfall Tax;
2. He has filed the required return thereunder;
3. He has paid any tax due under such return;
4. He has filed a claim under Title VII.

The taxpayer may file an application to the Commissioner, requesting the joining of the Windfall Tax and the claim for refund as one case for his consideration.

The Windfall Tax is an annual 80 per cent tax on the net income received by a taxpayer during the year 1935, or in subsequent taxable years, from any of the three sources previously mentioned. The tax base will be whichever of the following situations will produce the lowest result:

1. Either the unpaid tax, or amount of refund, or the amount of reimbursement received from the vendor; or
2. The net income from the sale of the article on which tax was unpaid, refunded or reimbursed; or
3. The amount of burden which is shown as having been shifted; or
4. Where the taxes were not paid, the net income from the article or commodity on which a tax was both paid or unpaid during the taxable year.

Computation of Net Income Where Tax Was Unpaid

In calculating the taxable net income of an article where the tax was not paid, or the net income from the sale of an article to the extent to which the burden of a tax was shifted, the law allows for two methods of computation. Upon the election of a particular method, however, the taxpayer is subsequently denied the right to change to the other.

Method No. 1 can be succinctly described as "the actual profit on specific transactions method"; and Method No. 2, as "the average margin of profit per unit method". Either of these methods may be employed in arriving at the calculation of the net income from the sales of the article (where the tax was not paid), or in computing the calculation of the extent to which the burden of the tax was shifted. In cases where a refund of tax, or reimbursement from vendors was received, the computation of the net income is simplified to the extent that the amount of refund or reimbursement represents the net income, subject only to those deductions, as will be more fully explained below.

Where the tax was not paid, the alternative methods of computation, once adopted, must be consistently followed for the purpose of calculating the following:

1. The amount of net income from the sales of articles with respect to which a Federal Excise Tax was imposed, but not paid;
2. The net income for the taxable year from sales of the articles on which the tax was both paid and unpaid;
3. The computation of the extent to which the burden of the tax was shifted to others.

Method No. 1, because of the nature of the information required, can only be used if the taxpayer maintains cost records, or such records as would permit identification of specific items. Method No. 2 permits the use of averages in those instances where the specific items cannot be identified.

The manner of computation of the net income from the sale of articles with respect to which the tax was imposed but not paid, under Method No. 1 —the actual profit from specific transactions method—is as follows: First, the

total sales of articles on which the tax was not paid must be ascertained. From this amount should be deducted:[9]

(a) Sales of articles on which the tax was not paid and which were not sold before January 6, 1936;

(b) Amounts af adjustments made with vendees in pursuance of agreements entered into before March 3, 1936, or in a bona fide settlement and payment before June 1, 1936;

(c) Any items on which, if the tax had been paid, same would be refundable under Title IV, because same would have represented deliveries for charitable distribution or use, exportations, or where there had been a decrease in rate, in accordance with a proclamation by the Secretary of Agriculture.

From the balance, after these exclusions, there should be deducted the expenses and fees, which would be limited to 10 per cent of the amount of the tax. The resulting balance which is given no name in the regulations, but which for our purposes we will call "net sales" would then be reduced by the cost of the goods sold.

The "cost of goods sold", for the purpose of this computation, would be the generally accepted accounting conception of this term. Article 10 of Regulations 96 discusses what is to be deemed "cost of goods sold". Such items as selling expenses, losses, interest on borrowed money and general administrative expenses are not to be included therein. In those instances where there was a recoupment from the taxpayer's vendors or any adjustments in the price of the commodity purchased because of the tax, then the "cost of goods sold" is to be reduced thereby.

The remaining balance ("net sales", less "cost of goods sold") is termed by the regulations "gross income", and from this, the taxpayer is permitted to deduct an allocable part of the deductions allowable pursuant to Section 23 of the Revenue Act, as deductions for the purpose of computing his income for normal and surtax purposes. Such expenses may be classified as:

1. All the ordinary and necessary expenses in carrying on a trade or business, including a reasonable allowance for salaries, travelling expenses, rentals and other payments for the use of property;
2. Interest, except such as is unallowable by the Revenue Act;
3. Taxes, with the same exception;
4. Losses not compensated for by insurance;
5. Capital losses, subject to the limitation of $2,000;
6. Bad debts;
7. Depreciation and depletion;
8. Charitable contributions limited to 15 per cent of income to individuals and 5 per cent of income to corporations; and
9. Payments and apportionment of payments to a pension trust.

The remaining balance represents the net income from articles sold upon which the tax was not paid. This would be the amount taxable if the com-

Footnote: (9) Exclusions under Section 501-B.

putation showing the extent to which the tax burden was shifted, is higher, or the net income for the taxable year on articles on which the tax was both paid and unpaid, is higher.

Under the "average unit" method, the total sales represent all sales of articles which were subject to tax, whether the tax was paid or not, and the only deduction from such total sales is the amount paid or incurred for legal fees and expenses. Such items as were excluded from sales in Method No. 1, are to be included in Method No. 2, to wit, sales after January 6, 1936; adjustments with vendees; and items which are ordinarily refundable, such as deliveries to charities, exportations, etc.

The "gross income" is determined in the same manner as in Method No. 1, except that "cost of goods sold", not requiring specific identification of items, would represent the total cost of taxable goods sold during the period. There is also deductible from the gross income, the allocable deductions as allowed under Section 23 of the Revenue Act, in a manner similar to that in Method No. 1. However, neither under costs nor expenses under Method No. 2, should there be included any Federal Excise Taxes paid, nor should any reimbursements which were made to taxpayer's vendees, be added. From this point, Method No. 2 differs, the balance of gross income, less allocable expenses, (the net income), is divided by the number of units which had been included in the computation of gross income of all items on which tax had been paid and not paid. Net taxable income is then determined by multiplying the quotient, net income per unit, by the number of units upon which the tax had not been paid, such number of units having been previously ascertained. In this manner the net taxable income does not include any income from articles which were sold after January 6, 1936, or income from items on which adjustments were made with vendees; or items where the tax would ordinarily be refundable.

Further amplification is necessary as to the manner of allocation of expenses allowable under Section 23 of the Revenue Act under the two methods of computation. The regulations state that deductions should be allocated to such items to which they may be specifically allocable. For items which are not specifically allocable, there is no general rule, but it is presumed that the facts and circumstances in each case will govern. The taxpayer should submit with his return, a statement showing the method and principles of allocation which have been used. The taxpayer or his accountant will probably determine which is the most equitable method of allocation, and the Commissioner will probably accept any method which appears reasonable and in accordance with proper accounting theory. Methods of allocation that suggest themselves may be as follows:

1. On the basis of sales;
2. Prime costs;
3. Number of units;
4. Direct labor;
5. Space occupied by particular process; or
6. A suitable combination of any of the above to specific items.

Computation of Net Income—Refunds and Reimbursements

The determination of net income, where the income received by the taxpayer represents reimbursements which he has received from his vendors, or where the income represents refunds which have been received from the Government, are less involved. The net income will be the amounts received or accrued as reimbursement with respect to any amounts representing Federal Excise Taxes; or the total amount of the refunds or credits from the United States Government. The taxable amount would not include, in the case of reimbursements from vendors, any reimbursements for articles which were unsold on January 6, 1936. Other exclusions permitted to these two classes of taxpayers would be adjustments which were made with the taxpayer's vendees (whether paid, credited or accrued) and such amounts for which the taxpayer would ordinarily have been entitled to obtain refunds. In determining the net taxable income, there may be deducted, the expenses and fees reasonably paid in obtaining such refund or reimbursement, limited to 10 per cent of the amount of such refund or reimbursement. The net income under this computation would be the taxable income, subject however, to decrease to the amount of the extent to which the burden was shifted, as will be discussed.

Computation of Shifting of Burden

The computation of the extent to which the burden was shifted by the three classes of taxpayers involves the adoption of either of the two alternative methods previously discussed. Either of such methods of computation may be used in the computation of the shifting of the burden for the three situations covered by Section 501-A. However, if an election was made for the purpose of computing "net income" under Section 501-A(1), such election of method must be consistently followed in computations of "shifting of burden".

Under Method No. 1, the "actual profit method", the taxpayer must ascertain the information and data, not only for the period during which the particular tax was imposed, but also for the six[10] full taxable years preceding such period. The first thing to be determined under this method is the total number of units, and the aggregate selling price of the taxable article in each of the periods. The selling price is deemed to be less trade discounts and cash discounts, if such cash discounts are in excess of a fair interest rate for anticipation of payment. The selling price may include transportation and delivery charges, provided that the practice in regard to all such items is consistent in all periods. Taxes are not to be deducted. Exclusions from the selling price would be articles not sold on January 6, 1936, items upon which reimbursement was made to the vendee and items which are ordinarily allowable, such as charities, exportations, etc. From

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Footnote: (10) It should be noted that for the purpose of obtaining a refund, figures for only two years preceding the tax period are necessary (and also six months after the tax period), but for the purpose of reducing the Windfall Tax or claiming entire exemptions therefrom, figures for six years preceding the tax period are required.

the selling price figure, there may be deducted the allowable legal expenses incurred in regard to the tax. The figure thus arrived at represents the aggregate selling price, from which is to be deducted, the cost. Cost for this purpose is defined by the law to mean only the cost of materials entering into the taxable articles.(11) Items such as labor, manufacturing expenses and overhead, are excluded. Materials are not limited, however, to direct materials, and it may be construed that overhead materials, if ascertainable, are includible. Cost, if the taxpayer does not manufacture, represents the purchase price of the articles bought for resale. The cost, in all cases, must be reduced by reimbursements received from the taxpayer's vendors. The resultant balance in our computations at this point, represents the "margin" with respect to the number of units as to which the net income was determined. From this "margin" there must be then deducted the "average margin" for the six years preceding the imposition of the tax in question, which average margin must be determined for an equivalent number of units as were included in the aggregate selling price, as heretofore determined. The "average margin" for the six preceding years (pre-tax period) is ascertained by a calculation similar to that used for determining the "margin" of the taxable period. The difference between the margin for the tax period and the average margin for the pre-tax period indicates the extent to which the burden was shifted to others. If the average margin for the pre-tax period is higher, it is presumed to be prima facie evidence that the taxpayer bore the burden, and there would be no tax liability under the Windfall Tax. However, if it is lower, the amount of difference between the margin and the average margin is the basis of tax, subject to the other limitations mentioned. These figures, however, do not necessarily have to be considered as conclusive, but may be rebutted.

If Method No. 2 (average margin per unit) is used, the procedure would be different in a number of particulars. The aggregate selling price would include sales of items during the taxable year, even if made after January 6, 1936, sales on which reimbursements were made to vendees, and items ordinarily allowable, such as charities, exportations, etc. The cost of materials would be determined in the same manner as under Method No. 1, except that specific identification would not be necessary. The resultant balance is then reduced to an amount per unit, it having been necessary to have previously ascertained the number of units involved under all classifications, taxable and otherwise, as well as the amounts thereof. The amount per unit is then further reduced by the average reimbursement to vendors made during the period.(12) The balance (after deducting from sales, the costs and reimbursements), represents the margin per unit. From this is deducted the "average margin" for the pre-tax period, which "average

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Footnote: (11) Section 501 F (2).

Footnote: (12) Paragraph 6 of Article 13 of Regulations 95 provides that the total reimbursement should be divided by the number of units, to ascertain the average reimbursements. Under Method No. 1, the specific reimbursements can be applied to the taxable items. However, see Article 1, P (K).

margin" is arrived at in the same manner as the margin for the tax period under Method No. 2. The extent to which the burden of tax was shifted, if any, is measured by the difference between the margin per unit during the tax period and the pre-tax average margin per unit. This difference is then multiplied by the number of units on which the tax was not paid or on which the reimbursement or refund was received, which produces the amount presumed to be the burden which was shifted and therefore the base subject to tax. However, if the pre-tax average margin exceeds the taxable period margin, it is an indication that the burden was not shifted, and there would be no taxable income subject to the Windfall Tax. Here too, the presumption is subject to rebuttal.

In cases where reimbursement or refund was received in one taxable year and the articles were sold in whole or in part in another taxable year, the margin and the extent to which the burden was shifted must be computed separately for each year, according to the years of sale of such articles.

There is another method of computing the extent to which the burden was shifted which should be mentioned. This method applies only in cases where the sales were that of services, such as custom slaughtering, custom milling, etc. In such cases, it is first necessary to ascertain the aggregate selling prices of the services subject to the tax which was not paid, or for which refund was received, less the exclusions and allowable legal expenses and fees. From such income is deducted the average margin of fees for such services during the six preceding years. The balance, if any, is presumed to be the amount of tax on which the burden was shifted.

In situations where the records for the six preceding years are not now available or cannot be ascertained and where the average margin must be calculated, as previously discussed, the regulations provide that secondary information may be submitted. The Commissioner may then determine average prices and average margins, by a comparison with the average of representative concerns engaged in a similar business and similarly circumstanced. The use of comparatives resembles somewhat the procedure under the famous special assessment sections [13] of the old 1918 Act, which may present a number of interesting problems and questions, as did that law.

Rebuttal of Presumption as to Shifting of Tax

As previously mentioned, the law and regulations provide that the computations of the extent to which the burden was shifted to others is a presumption which is prima facie, but which may be rebutted by either the taxpayer or the Commissioner. The taxpayer may establish the actual amount of tax which was shifted by other means, or show that he did not shift any part of it, and solely bore the burden thereof, despite the figures submitted in accordance with requirements. In submitting evidence to rebut the presumption

Footnote: (13) Sections 327 and 328 Revenue Act of 1918.

of the statutory computed margin or average margin, proof of other factors affecting the margin or the average margin may be submitted, such as:

1. That the articles which were sold, though similar, are different as to type or grade;
2. That the articles in the periods are different, either as to the article itself or as to the materials from which manufactured;
3. That changes in cost of production have been effected, which do not make periods comparable;
4. That there have been modifications of the terms under contracts of sale which have affected prices and offset differences;
5. That the burden of the tax was reflected in changes in the article, such as size, package, discount, terms or other merchandising practice;
6. That the taxpayer billed the tax to the vendees separately, or indicated in writing that the price included the amount of tax;
7. That the taxpayer contracted to refund a specific part of the sales price as representing the tax, in the event that the tax was declared invalid, and that he has either done so or is liable to do so.

Identification of Items, Conversions, etc.

In all references to units of commodities or articles subject to the tax in the various computations, it is necessary that such units be converted and expressed in the terms of the units on which the tax is based, and if the taxpayer's records do not show adequately the details of the quantities and materials entering into any article, then the conversion factors prescribed by the Treasury decisions and regulations will apply. If the taxpayer cannot identify the specific items with respect to cost, selling price, etc., in the determination of what is the cost or selling price of such articles, the rule of first-in-first-out will be used. All figures of sales, costs, etc., which are submitted, are subject to the test that they are bona fide, and where the transactions are not deemed to have been made at arms-length, the Commissioner may determine the fair market price of such sales or purchases. Sales to, or purchases from, a corporation owned or controlled by the taxpayer or under common ownership, will be subject to special scrutiny, to determine whether the transactions were at a fair price.

Credit for Income and Excess-Profits Taxes

In the final computation of the amount of tax payable under the Windfall Tax, a credit may be taken for the amount of income and excess profits tax which resulted because of the inclusion in taxable income of the amounts subject to this tax. It seems that this credit would also apply to the tax on undistributed profits, because such taxes are also classified in the Revenue Act as "income taxes". It should be noted, however, that credit may not be obtained for any Federal income or excess profits tax, unless the taxpayer was actually liable to pay such taxes for the particular year and that credit may not exceed the amount for which such taxpayer was liable to pay under the

Windfall Tax. The computation of this credit is not based on the unpaid tax, reimbursement or refund, but on whichever is the amount which is deemed to be the "taxable income" base for the 80 per cent Windfall Tax. A thought on this item presents itself in cases where the question of declaration of dividends is being considered in regard to the tax on undistributed profits. Saving the taxpayer from the effects of the undistributed profits tax may mean only that a greater amount would be payable under the Windfall Tax. It would probably be better, when a taxpayer's income or a portion of such income is subject to the Windfall Tax, that the amount should not be declared as a dividend, because since it must be paid under this tax, there would be no justification for also burdening the individual stockholders.

Returns

The returns for the current year 1935 and for the fiscal year ending prior to the passage of the Act are now due, but filing has been extended to December 15, 1936. Returns for fiscal and calendar years ending after June 22, 1936, are due at the same time as regular income tax returns. Taxes may be paid in the same manner as other income taxes, but the Commissioner is authorized to grant an extension up to six months, if the taxpayer so requests.

Constitutionality of Windfall Tax

In closing, it might be advisable to point out that the constitutionality of the Windfall Tax (Title III) has been brought into question. Among the serious arguments urged against it, in a copy of a memorandum prepared by an eminent counsel with whom I have been associated, are:

1. That the tax is an indirect effort to collect the AAA tax, which the Supreme Court held unconstitutional;
2. That it is not an income tax, but a direct tax, which would have to be apportioned among the States.
3. That it does not apply to all those who have been unjustly enriched, because it does not tax those who shifted the burden, but have no net income for the period.
4. That if the taxpayer had no net income from his business transactions under Title I, and sustained a loss from the entire year's activities, there could be no "net income" from a special source.

In this connection, the early experience of taxpayers should be borne in mind, as has already been brought out, that the position of contentious litigants is often better than that of acquiescent taxpayers. It may well be that the cautious taxpayer (as I know has been done recently) will seek to protect himself by bringing an injunction suit to test the validity of the tax, and to have his money impounded in court, which would serve as a guarantee of repayment in the event of the unconstitutionality of the law.

In the event of such adverse adjudication of the law, such taxpayers will be spared the long delay of securing a refund of moneys already paid to the Government.

I have tried to avoid any discussion as to the possible unfairness of the law, or as to whether or not the taxes are wise. Like Mr. Green who spoke at our last meeting, I have endeavored not to let such views enter into a consideration of the validity, meaning and procedure which I have tried to explain, especially those pertaining to the accounting requirements of Titles III, IV and VII of the Revenue Act of 1936.

Note: Due to the fact that the next issue of "The New York Certified Public Accountant" will be published in January, 1937, and the fact that many provisions of the Titles in the Revenue Act covered by this article require action by December 15, 1936, it was felt desirable to make a Special Issue on this particular subject.

Committee on Publications.

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